1941

Accounting, Auditing & Taxes 1941, Papers Presented at the Fifty-Fourth Annual Meeting of the American Institute of Accountants

American Institue of Accountants

ACCOUNTING, AUDITING, AND TAXES — 1941

ACCOUNTING AUDITING & TAXES

*

1941

FEDERAL TAXES — CASE STUDIES IN AUDITING—DEFENSE CONTRACTS—FORMAL AUDIT PROGRAMS — STAFF TRAINING METHODS — DEPRECIATION — RESEARCH AND TERMINOLOGY — AUDITORS' REPORTS — STANDARD COST SYSTEMS — WAGE AND HOUR LAW—BETTER ENGLISH—ADDRESSES

THE·AMERICAN·INSTITUTE·OF·ACCOUNTANTS

PAPERS PRESENTED AT THE
FIFTY-FOURTH ANNUAL MEETING OF
THE AMERICAN INSTITUTE OF ACCOUNTANTS

ACCOUNTING
AUDITING
&
TAXES
1941

PAPERS PRESENTED AT THE
FIFTY-FOURTH ANNUAL MEETING OF
THE AMERICAN INSTITUTE OF ACCOUNTANTS

13 East Forty-First Street, New York, N. Y.

Price: One Dollar

CONTENTS

FOREWORD

THE PAPERS published in this book were presented at the fifty-fourth annual meeting of the American Institute of Accountants, held at the Hotel Statler, Detroit, Michigan, September 15–18, 1941.

The interest of the profession in keeping itself informed of current developments in taxes, accounting, auditing, and defense is demonstrated by the fact that over 1,300 persons came to Detroit from all parts of the United States to attend sessions on these subjects. The addresses they heard are compiled in this book.

As the address presented by William W. Werntz, chief accountant of the Securities and Exchange Commission, entitled "Progress in Accounting," was published in the October, 1941, issue of *The Journal of Accountancy*, it is not included here.

Address of Welcome

BY ARNOLD L. BARRETT
President, the Michigan Association
of Certified Public Accountants

FIFTY-THREE times an accountant has stood before the national professional body and welcomed its members to the place where their annual meeting happened to be held. I am proud to be the 54th. I can't hope to increase the cordiality of the welcomes that have been given before, but I assure you that we of Michigan are as heartily glad to have you as our guests as any others who have had that honor. We don't hope to better the performance of those hospitable people who have entertained us all in recent years, but we have done our best to prepare a profitable and pleasant meeting. Naturally, we anxiously hope that you will like it.

The one thing that does distinguish this meeting from others is entirely extraneous: it is the war abroad and what it may mean to us. None of us can know what personal hardships lie ahead nor what changes in our social, political and economic system. We do know this, however, that as long as private enterprise persists in this country, the accountancy profession will have a vital part to play in our economy.

When each of you has heard the technical addresses and discussions which will take place here in the next few days, and has met the men here who represent the accounting profession throughout the United States, I think you will agree with me that our profession will succeed in adjusting itself to the demands of the times and in meeting any challenge with which it may be confronted.

This year marks the fortieth anniversary of the Michigan Association of Certified Public Accountants. We feel it very fitting and a high compliment to us that the national organization should help us celebrate this event by holding its annual meeting in Michigan at this time.

I

Auditing Procedure

Chairman: EDWARD A. KRACKE, NEW YORK *September 16, 1941*

Introduction

BY EDWARD A. KRACKE, NEW YORK

Member, committee on auditing procedure,
American Institute of Accountants

WE HAVE come again to the time of our annual "stock-taking," when we pause to survey in retrospect the progress which we have made in auditing procedure in the year that is past, and to look forward to the new problems that lie ahead. Each year brings its new problems with their responsibilities and opportunities, their new thoughts and new concepts. And new concepts bring with them the need for clarification, so that there may be understanding. Our papers this afternoon are the Institute's contribution to that understanding.

A new concept introduced during the past year into the accountant's report or certificate is that of "standards" of auditing; with its appearance there have arisen queries of "what" and "wherefore." We speak of "principles," when our subject is accounting; and now we speak of "standards," in relation to auditing. Why the distinction?

In our field of accounting, and the proof of accounting, which is auditing, we have to do with both the science and the art of each. Science is theory, art is practice and procedure. Science is concerned with principles for observance, art with standards for performance. But the standards of art must always conform to the principles of science.

As I view it, the opinion or concluding paragraph of the short form of accountant's report is thus concerned with the science rather than the art of accounting—with the principles of the science of accounting observed in the financial statements in question rather than with the standards of the art of accounting by which they were produced; for example, the client's work may have been done, on the one hand, with the best possible mechanisms of internal control, or it may have been done, on the other hand, with only the most embryonic type of internal control—differences which may denote a wide disparity of standards of performance, differences which may spell a contracted or an expanded work program for the auditor, but not differences as to the truth of the results portrayed in either case.

As opposed to this, the scope or opening paragraph of the accountant's report is concerned particularly with the art of auditing and its standards for performance; for it is on proper performance that the worth of the opinion expressed depends.

What level of performance does a standard signify? Words frequently have such varying shades of meaning that this one may well give concern lest the understanding of the accountant and that of his public do not meet on a common ground. With the fundamental meaning of a measure, as our lexicons explain a "standard" to us, the danger of misunderstanding does not exist with the simpler concept of a measure of quantity (for we easily comprehend standards of weight and linear measure) but that danger does arise when it is quality that we are measuring. Here we find our lexicons speaking now of "average," now of "perfect," with an undetermined place for the connotation of "standardized." For us, standard means the quality of competent work by a capable man.

But that quality must not be confused with perfection. It is the paradox of mortal man's existence that perfection is ever the end to be striven for, only to remain an end never to be attained. The thing we must always be mindful of, in this world where nothing remains unchanged, and where standards therefore also must move, is that they be not lowered but raised—not impaired but improved; and this thought of there always being room for improvement will effectively gainsay any erroneous thought of perfection already attained.

Moreover, standards will always be in some degree general, no matter how refined; they can never be set up in minutiae, to cover all the conditions, all the circumstances and all the contingencies that may be encountered; they will hardly tell us the precise extent of testing required in a given instance. That being so, to contend that the mention of adherence to standards is a representation of fact detached from opinion and judgment is to place credulity over intellect.

Furthermore, performance must not be misjudged. The lawyer may lose a case for his client despite the excellence of the legal service rendered by him. The surgeon may not have saved the life of his patient although the proper operation may have been ever so skilfully performed. In the whole matter of standards, it is a fallacy to indulge in any such specious reasoning, from ostensible effect to alleged cause, as to reach a conclusion, that because an error—even conceivably a material error—may not have been discovered, therefore the work of the auditor is *ipso facto* to be condemned as not having been fully up to professional standards.

This is a little more clearly understood when one considers such things, for instance, as collusion; for the ramifications of collusion may in conceivable cases be such as to defy standards set up in a world of practicalities to meet situations of varying degrees of likelihood, short, however, of highly unlikely ones. In other words, there must be no misconception in the minds of the accountant's public that the opinion expressed by him in his report, based on maintained standards of auditing, has any of the attribute of a guarantee.

Auditing Standards

BY SAMUEL J. BROAD, NEW YORK

Chairman, committee on auditing procedure,
American Institute of Accountants

CERTAIN fundamental principles or basic concepts of human behavior necessarily underlie the independent public accountant's relations with his clients and with the general public.

Honesty, integrity, truthfulness, and courage are the background of his work. He must have an honest opinion and be prepared to express it clearly and forthrightly. He must be independent and be prepared to exercise independent judgment on the facts disclosed by his examination.

Due Care

The exercise of "due care" is among the most important tests of a man's business and social relationships with his fellows. By it many of his responsibilities are measured, whether they relate to erecting a building, driving an automobile, or cleaning sidewalks. Some of the standards of what constitutes reasonable care have been fixed by statutory law or government regulation as, for example, the presumption of reckless driving if a certain rate of speed is exceeded, or the time allowed for clearing snow off sidewalks.

As a rule, the standards remain comparatively fixed or, if changed, the modifications come about gradually and infrequently in response to public need and public demand, or changed conditions.

But frequently the determination, as a question of fact, whether the standards of due care have been exercised in the circumstances of a particular case is a matter for judicial decision and has resulted in a series of decisions constituting case law.

The established standards of what constitutes due care are influenced by the number of people affected by the risk.

Automobile speed limits are lower in congested districts than in the open country; fire escapes are found in apartment houses but not in private houses; employees' liability insurance is required where the number of employees exceeds a minimum.

The standards of reasonable care seem to be influenced also by the materiality, and degree, of the risk involved. The risk of a wreck is no greater to a passenger train than to a freight train but what is risked is human life instead of property; hence the raising of the standard by the substitution of metal for wooden passenger cars; safety devices required for machinery increase where the danger to life and limb of employees is greater.

Reasonable Evidence

The same broad principles which underlie the standards of "due care" in other relationships would appear to be applicable to the auditor's work also. The expression of a professional opinion regarding financial statements must be based on reasonable evidence weighed with reasonable skill and judgment. It presupposes that an examination has been made with reasonable care and a reasonable degree of skill by one qualified to make it. In furnishing such an opinion, the auditor must have reasonable grounds for his belief whether the statements present fairly the position of the enterprise at the date stated and the results of its operations for the period, in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding period. What constitutes reasonable evidence to support such a belief will control the entire scope of the examination and, assuming that reasonable skill has been exercised, will determine whether the auditor has exercised "due care."

Thus the purpose of auditing procedures should be to accumulate as much evidence as reasonable men would consider sufficient to warrant a conclusion, having due regard to practicability and justifiable expense. But evidence is seldom conclusive and the auditor's report cannot be regarded as a guarantee. In spite of what appears to be adequate evidence, he may in rare instances be misled and arrive at an incorrect conclusion in circumstances in which blame cannot fairly be attached to him. Even the conclusion of the twelve men of a jury occasionally results in the miscarriage of justice. Though we sympathize with the unfortunate victim, we do not hold the jury accountable.

Materiality

There should be stronger grounds for belief in respect of those items which are relatively more important and in respect of those in which the possibilities of material error are greater. For example, in an enterprise with relatively few, but large, accounts receivable, the individual items themselves are more important, and the possibility of major error is also greater, than in another enterprise which has a vast number of small accounts aggregating the same total. In industry and merchandising, inventories are of relatively great importance in both the balance-sheet and the statement of income, and should receive relatively more attention than, say, the cash on hand; or again, than the inventories of a utility company. Similarly, accounts receivable will receive more attention than prepaid insurance. Whether we put it in words or not, the principle of materiality is inherent in our work.

Relative Risk

The degree of the risk involved also has an important bearing on the nature of the examination. In the light of possible irregularities cash transactions are more vulnerable than inventories and the work undertaken on cash should be carried out in a more conclusive manner.

Titles to properties, again, may be as valuable as marketable securities owned, but they are not negotiable instruments and thus the standards of audit procedure in their examination are less exacting. Arm's-length transactions with outside parties are usually subjected to less detailed scrutiny than those relating to intercompany transactions or those with officers and employees, where the same degree of disinterested dealing cannot be assumed. Or from another angle, more attention may be given to repair charges in the case of a company with profitable operations, where the tendency may be to charge improvements as repairs, than in one which is unprofitable, where the tendency may be to capitalize repairs. In the latter case closer scrutiny of items capitalized may be necessary.

The effect of internal check and control on the scope of an examination is the outstanding example of the influence on auditing procedures of a greater or lesser degree of risk of error. The primary purpose of internal check and control is to minimize the risks of errors and irregularities, and the more adequate and effective the system, the smaller the risk and the less extensive the detailed examination and testing required.

The auditor's reliance upon internal check and control is based upon the belief that if a number of persons take part in initiating, carrying through, recording, and controlling a transaction, the probabilities are very strong that the transaction is a real one and is properly recorded, and especially if the individuals are independent of one another and are physically separated. On the other hand, where the internal check and control are necessarily limited or severely restricted, the examination to be made should be more comprehensive in character. In short, we come back to the principle that the relative risk involved influences the audit program to a major extent.

Desirability of a Statement of Auditing Standards

An independent public accountant's opinion regarding the financial statements as a whole must be based on his examination of evidence which competent auditors would consider reasonable in the circumstances. It must be up to standard.

I regard auditing standards as occupying an intermediate position between broad general principles at the one extreme and the detailed specifications as to the methods to be adopted and the extent of the tests at the other extreme. While there will be substantial variation in the means of attaining the standards under different circumstances and by different practitioners, there can be no doubt as to the necessity of attaining them. Standards may be looked upon as the specific objectives to be attained by means of audit procedures and not as the audit procedures themselves. Perhaps I can illustrate best the distinction I see by an example from another profession. The standard of due care in an operating room requires absolute cleanliness, but it does not dictate what instruments a surgeon shall use or the exact length of the incision. The standard of cleanliness also applies in the hospital ward, but the procedures—masks, gowns, gloves, etc.—are not so meticulous because the risk of infection is less.

In driving a car one standard of due care is to have brakes and headlights in order; the driver must keep on the proper side of the road and stop at stop streets; he must not exceed the rate of speed established by law. These are simple standards by which to measure due care and have been set down as a result of the combined experience of those whose business it is to regulate motor traffic; and the driver usually knows whether he meets them.

What comparable standards have we in the function of auditing? Many treatises, textbooks, and bulletins have been written dealing with procedures. In practice, ingenuity has been exercised in developing new or different kinds of procedures to meet the development of modern and improved corporate accounting. Short cuts, test checks, overall checks, the analytical method of approach, have all been developed and are still developing as added means of confirmation, and oftentimes as substitute means for the more detailed auditing checks once more common. This trend away from detailed checking has been accelerated by the marked improvement in corporate accounting, and particularly by the improvement in methods of internal check and control and the consequent lessening of the risk of material error. But with all these more recent developments the establishment of a code of auditing standards has not proceeded to any great extent; and perhaps with a young and growing profession, it is well that this should have been the case.

However, with the increased demands made upon us and with the increasing responsibilities which we are being continuously called upon to assume—demands and responsibilities which we should not shirk if we are to attain our full stature—I believe the time has come when we should establish, and call for the attainment of, certain minimum standards in our work.

In its report to council last May the committee on auditing procedure stated that it had reached the conclusion that before proceeding further with the revision of the bulletin, "Examination of Financial Statements," it might be desirable to deal first with the more fundamental subject of auditing standards.

There need be nothing revolutionary in a statement of auditing standards; it entails rather the setting down, or codification, of standards which competent practitioners already recognize in their individual practices. Some action of this kind seems almost essential in view of the recent revision of the Securities and Exchange Commission's rule on "Accountant's Certificates." The rule now requires a statement that the examination has been "in accordance with generally accepted auditing standards applicable in the circumstances." While we probably all carry in our minds a conception of what such standards are, it nevertheless seems desirable that they be specifically stated.

Auditing Standards

With this introduction and with this background, let me attempt to specify in a preliminary way auditing standards which I believe have been sufficiently established by professional and other authority to have attained that rank.

General

(1) Consideration should be given throughout the course of the examination to the accounting practices applied with a view to reaching a conclusion as to whether they are in accordance with generally accepted accounting principles; and whether such principles were applied on a basis consistent with that of the preceding period.

(2) The scope of the auditor's tests of authenticated vouchers, documents, and other supporting data should be sufficient to satisfy him that transactions recorded actually occurred, and that the accounting values which resulted from these transactions are properly stated.

(3) Documentary evidence or other authorizations should be seen in respect of those acts or transactions involving the accounts which require formal approval by the state, the stockholders or directors, or other authority.

(4) Throughout the course of his work, whether in examining or testing vouchers or in specific inquiries on the subject, the auditor should endeavor to satisfy himself as to the reasonable adequacy and effectiveness of the system of internal check and control in the light of the conditions encountered in the particular enterprise; whether the system, in principle, should produce reliable results; whether it functions satisfactorily as planned; and whether it does produce reliable results as indicated by the tests made. This involves knowledge of duties assigned to individuals whose reports form the basis for accounting entries, the scope of their duties, and the extent of their authority. If weak spots are encountered, the auditor should decide whether his testing or sampling of the particular type of transactions should be extended.

(5) Consideration should be given to the internal auditing program, if any, carried on within the client's own organization, the degree of reliance placed on such auditing being dependent on the independence and skill of the internal auditing personnel. The objective should be to economize effort and to increase the reliability of the financial data through proper planning and coordination of the two auditing efforts.

(6) *Assets.* Inquiries should be made to ascertain whether the assets are free or are hypothecated or subject to lien or other encumbrance.

Cash

(7) The examination of cash on hand and in banks should be undertaken as at the same time that securities, bank loans, etc., are counted, taken under control, or confirmed.

(8) Count or direct confirmation with independent holders should be made of all material balances. The auditor should be satisfied as to the reconciliation of all differences between the amounts as confirmed and as shown by the books and that the cash in banks is held in a bona fide bank; and should ascertain if there are any restrictions on withdrawal.

Receivables

(9) The individual accounts should be examined or analyzed and the system under which they are maintained reviewed to the extent necessary to support the conclusion that the accounts represent real receivables and to enable the auditor to form an opinion as to the approximate amount which they may be expected to realize.

(10) Wherever practicable and reasonable, confirmation of receivables should be made by direct communication with debtors, the method and extent thereof to be determined by the circumstances.

Inventories

(11) The auditor's opinion as to the inventories must be based on his examination of the accounts, the stock records (if any), and other data supporting the

inventories, supplemented by his review of the methods and basis of taking and pricing the physical inventory itself. The extent of his tests of the records should be such as to satisfy him as to their bona fides and reasonable accuracy.

(12) The examination should include inquiry into, and a review of, the instructions for determining inventory quantities to see whether they are such as may be expected to produce a reasonably careful determination of quantities, quality, and condition. Consideration should be given to the methods adopted for cut-off purposes, i.e., the coördination, as to the receipt and shipments of goods and as to goods on consignment, etc., of the books of account with the physical inventories.

(13) Wherever practicable and reasonable, the auditor should attend the inventory-taking and observe the procedures followed (or make test checks) to a sufficient extent to ascertain whether the methods actually used for inventory purposes are conducive to a careful inventory. Where a material amount of the inventory is held by outside custodians, written confirmation thereof should be obtained direct from the custodians.

(14) The auditor should make inquiries and sufficient test of inventory prices to justify opinions whether the basis of pricing adopted conforms to generally accepted accounting principles and whether (a) the work has been carefully and conscientiously done; (b) adequate recognition has been given to market prices where these are below cost; and (c) reasonable consideration has been given in pricing to slow-moving or obsolete stock.

Securities

(15) The auditor should satisfy himself that the basis on which securities are stated is in conformity with generally accepted accounting principles and that allowance for shrinkage has been made where required.

(16) Securities should be confirmed by inspection or by confirmations from independent holders.

(17) *Plant and Equipment.* The basis on which plant and equipment are carried in the accounts should be ascertained, and the accounting policies as to the treatment of depreciation, betterments, additions, retirements, repairs, and replacements; and whether these are dealt with in accordance with generally accepted accounting principles. Sufficient test should be made to ascertain whether the basis used and the policies adopted have been followed consistently in the accounts.

(18) *Deferred Charges.* The auditor should satisfy himself, by documentary or other evidence, whether amounts carried forward as deferred charges are properly allocable to future periods and whether the policy and practice as to amortization of the respective items are in accordance with generally accepted accounting principles.

Liabilities

(19) The auditor should adopt procedures necessary in the circumstances, with due consideration to the system of internal check and control, to obtain reasonable assurance that no significant liabilities have been omitted and that reasonable provision has been made for accrued liabilities.

(20) Liabilities to banks, trustees, and mortgagors should be confirmed by direct communication with creditors, and liabilities to others if considered necessary in the circumstances.

(21) *Contingent Liabilities.* Inquiries should be made of the most authoritative sources reasonably assessable as to the existence of contingent liabilities such as notes discounted, litigation, guarantees, endorsements, etc.; also as to the situation regarding commitments and whether there are indicated or prospective losses.

(22) *Reserves.* The auditor should analyze the reserve accounts, investigate their reasonable adequacy for the

purpose for which provided and see whether they are being utilized for purposes other than those for which they were created or in any manner violating generally accepted accounting principles.

(23) *Capital Stock.* A review should be made of the minutes and other corporate records in support of transactions effected, including the authorization and issuance of capital stock, stock options, warrants, rights and conversion privileges, giving due consideration to statutory requirements. Securities issued should be confirmed by communication with the registrar and/or transfer agent or by reference to capital-stock records.

Surplus

(24) To the extent practicable the nature of the surplus should be determined, i.e., whether it represents undistributed profits, paid-in surplus, or other type of capital surplus; and whether any restrictions on surplus exist affecting the payment of dividends, etc.

(25) The auditor should consider the propriety of all charges and credits to the various surplus accounts with special emphasis on whether proper distinction is made between profit and loss, earned surplus, and other surplus.

(26) *Income and Expense Accounts.* The test or check of the operating and profit-and-loss accounts should be sufficient, combined with or supplemented by the corroborative evidence of the internal check and control and the examination of balance-sheet accounts, to support the genuineness of transactions recorded, their reasonable accuracy, and their proper classification. If the accounts are poorly kept or the system of control defective or ineffective, the examination should be extended until the auditor is satisfied whether or not the accounts are fairly presented. Comparisons with previous periods and other statistical methods will be useful in bringing to light such matters as merit special attention.

I think there will be little disagreement with my suggestion that these twenty-six standards have been authoritatively recognized. They must necessarily be couched in general terms. They could doubtless be more accurately stated; doubtless too, other standards could and should be added. Perhaps some of those I have listed are procedures rather than standards and should be excluded. For the most part they deal with what is to be done rather than how it is to be done. They occupy an intermediate position between what I think we might call the underlying or controlling principles of auditing—reasonable evidence, materiality, and relative risk—at the one extreme, and the detailed specifications of procedures, the programming of the audit, at the other extreme. They leave full scope for the exercise of professional judgment as to the "how" and the "how much" of auditing, and ample room for the development of new procedures.

Application of Standards

Auditing standards must, of course, be subject in their application to the controlling principles of auditing; in fact they flow out of them. For example, if there is an insignificant amount of securities and these are not readily marketable, the principles of materiality and relative risk come into play; the requirement that the securities be examined at the same time as cash and bank balances are confirmed becomes of minor importance. Or again there may be a very large number of relatively small cash change funds held by different custodians scattered throughout the country, which are checked by internal auditors periodically. The risk of anything more than a relatively insignificant error may be so small as not to warrant the time and expense of independently counting the funds.

These examples merely serve to emphasize the importance of the task of applying procedures to meet the auditing principles and standards. Here judgment and professional skill and experience must be paramount. The range of variations in the individual, in his skill, his reactions and his experience, and in the circumstances surrounding the individual situation he encounters, is too infinite to be reduced to rule. It is impossible satisfactorily to substitute mandate for judgment, taste, and skill. It has been tried, unsuccessfully, in too many fields of human endeavor and human behavior. For us to try it would, in my view, be to abdicate our position of responsibility and nullify our claim to professional standing.

In what position then does this leave the independent public accountant sincerely desirous of living up to the standards of his profession? How is he to know what a jury of his peers would consider reasonable in the circumstances? Where is he to find the answer to the "how" and the "how much" of auditing? He can exercise his skill and experience and apply his individual and personal judgment to the circumstances, but what guide is there to tell him whether the resulting examination has attained the necessary standard? The idea of care is clear, but what is *due* care? Like every qualifying word "due" introduces elements of judgment. Instantly it focuses attention on all the circumstances surrounding the situation and the standards of what others would do in those circumstances. Only in reference to these can its attainment be judged.

In searching for the answer let us again consider another profession. An attorney, in considering his client's position in a doubtful case will review the details of cases which have previously been decided in an effort to find one which approximates as closely as possible the case in hand. He is guided by such precedents. There are, however, few cases in which the details of auditing procedure have been the issue. And even on some of these many of us would hesitate to rely today in view of the advances made in auditing technique.

This dearth of authoritative precedents, even though it may be cause for self-congratulation, leaves us without a recognized and objective yardstick against which to measure our individual judgments as to what we can reasonably be expected to have done in particular circumstances.

I believe the greatest service which the Institute's committee on auditing procedure can render to practicing accountants is to try to provide such a guide. In its report to council previously referred to, the committee suggested that a statement of auditing standards be followed by a series of bulletins dealing by the case method with various questions that arise. "It would be possible, for example, to indicate the different types of procedures with regard to inventory quantities which might be necessary or desirable under specified circumstances to meet the auditing standards applicable to inventory quantities."

At a subsequent meeting the committee decided to proceed with the program it had suggested. The first step will undoubtedly be a preliminary statement of auditing standards to which additions will be made as occasion warrants. The second step will be the preparation and publication of case studies. As I visualize case studies, they should deal with specific items or types of items to be audited, and indicate the nature and extent of the confirmation, the amount and weight of the evidence, which the committee believes should be considered satisfactory in specified circumstances. To prepare such case studies will be a lengthy and by no means easy task.

Such a program should be both constructive and instructive and should have the further advantage of promoting a clearer understanding in the public mind of the proper sphere of an auditor and of the nature of his work and his responsibilities. It conforms to a proper conception of the nature of professional work and in the long run should also result in improved performance.

It is not to be expected that pronouncements of the committee based on case studies will carry the same weight as judicial decisions. They must necessarily depend for their authority upon their inherent reasonableness and upon their acceptance by the accounting profession and those with whom it has dealings. But if the pronouncements meet these tests I cannot but feel that they will be very influential and in course of time come to be recognized by the courts and others as a guide established by the accounting profession as to what constitutes "due care."

Case Study in Auditing of a System of Internal Check

BY A. J. BLOODSWORTH, DETROIT, MICH.

Member, American Institute of Accountants

THERE is considerable misunderstanding on the part of the public of the term "internal control." We all know of individuals who interpret it to include matters which are not connected in any way with accounting. It is, therefore, important to emphasize at all times that the term, when used by accountants in their reports, refers only to such control of a company's affairs as is exercised through accounting procedures and methods.

It should also be emphasized that, while the ultimate objective of all systems of internal control is the same in all cases, there are probably no two systems which are alike. There are many reasons for this. The most obvious being the different ways of doing business as between industries and in turn as between individual companies within a particular industry. For example, the system of internal control for an automobile company would differ considerably from that of an investment trust. While the underlying principles or practices relating to the auditing of a system of internal control are the same in practically all cases, the emphasis placed on the various auditing procedures will vary considerably as between companies.

Determining the various weaknesses in a system of internal control presents a difficult problem because what appears today as a minor weakness of the system may appear tomorrow, in the light of subsequent events, as a major weakness.

For example, there was the case where an accounts receivable ledger clerk acted as a relief cashier for a few hours each week. The company's independent auditor called this situation to the attention of the management of the company and suggested it would be advisable to have someone for relief cashier who was not engaged in the keeping of the accounts receivable. The management of the company after considering the matter decided this was not a serious or major weakness in their system of internal control and did not make any change. Some three years later the auditor discovered the relief cashier had taken some $9,000 by manipulating certain accounts receivable. There was also the case where a company having a large number of employees did not have its internal audit staff make any actual test pay-offs or other tests for the purpose of determining if there had been any padding of the payrolls on the grounds that such a thing could not occur under the payroll procedures and methods followed by them. The auditor was satisfied with the company's system of internal control in respect of payrolls but suggested it would be desirable for the company's internal audit staff to make such tests. The internal audit staff finally *proceeded* to make actual test pay-offs of the men and to account for each man selected for the test even if it involved going to his home. To everyone's surprise it was found, due to collusion, that a certain amount of padding of the payroll had been going on for sometime.

It is obvious that when a major weakness is detected in the *system*, steps should be taken to increase the scope of the audit until such time as the weakness is corrected. Most officials of companies are willing to correct, in so far as possible to do so, all major weaknesses in their system of internal control, but there is often considerable reluctance on their part to correct the minor weaknesses. When an auditor insists on having minor weaknesses of a system corrected he often gets no farther than having himself accused by the company's staff of being a type of person who mistrusts everyone. Another problem is the best method to follow in bringing to the attention of officials of a company weaknesses in a system of internal control. There is sometimes differences of opinion as to who should be advised and how it should be done.

The development of a system of internal control or check is predicated upon a division of duties and responsibilities in such a manner as to provide for the participation of a number of employees in the various procedures involved in a transaction to the end of ensuring the company maximum protection and control. The extent to which the duties are divided is contingent upon the character of the operations and the size of the organization. It, therefore, is essential, at the commencement of an inquiry into the system of internal control, to have an understanding of the nature and scope of the operations of the company.

The general inquiries made into the system of internal control of the company selected as our case study may be briefly outlined as follows:

The initial inquiries were directed to obtaining or sketching out a general chart of organization showing the duties and responsibilities assigned to the principal executives and employees, as well as supplemental charts indicating the departmental divisions of the business and the duties of the principal employees in such departments.

After the organization charts were carefully studied the operations of the company and the functional division of duties were discussed with several of the principal officers and employees to develop among other things information regarding the following:

1. Location of principal operating plants and sales offices and duties of principal personnel;
2. Relative importance of the various operating units, and nature of their respective operations;
3. Principal sources of material supplies and information as to whether or not purchases are made independently by each unit or through a central purchasing department;
4. Principal products manufactured, and how sales of product are effected, i.e., through dealer organization, through company-owned stores, or through contacts of company salesmen with customers, etc.;
5. *Is* the company dependent upon a few customers or is the business widely scattered over a large number of customers, and is the business seasonal or otherwise;
6. Terms of sale, i.e., for cash, long- or short-term installment sales, on open

account, or promissory notes and methods of collection;
7. The extent to which stocks are shipped on consignment or lodged in public or company-operated warehouses, and the manner in which such stocks are controlled;
8. Whether or not the company's product is subject to obsolescence as a result of technical research, changes in model or design, fashion, trends, etc.;
9. Position of company in field and principal competitors;
10. Brief synopsis of development of company.

As the company's transactions finally lead to entries in the books of account, and, in order to form an opinion as to the propriety of the entries it was necessary to have an understanding of the nature of the transactions and the procedures surrounding them from their inception to the final recording. For instance:

The inference drawn from a balance in the accounts-receivable ledger was that a certain kind of transaction had taken place between the company and another company or individual, but, unless the procedures leading up to the entries resulting in the balance were thoroughly understood, no opinion could be reached as to whether or not the balance was bona fide. In order, therefore, to pass upon the validity of the final recording of the transaction it was essential that the procedure inquiries be followed through from the inception to the completion of the transaction, and in the case of accounts receivable balances, for example, this involved a study of the procedures leading up to both charges and credits. As to the charges, the inquiries started in the department where sales originated and these inquiries were continued through the various departments, such as credit, shipping, traffic, billing, etc. Similarly, inquiries into the credits to accounts receivable in respect of cash collections were started at the source and such inquiries concerned themselves with ascertaining the methods of effecting cash collections, the handling of remittances received in the mail or otherwise, and the procedures in the cashier's department, etc.

Having made a study of the procedures leading up to the recording of the transaction in the customers' ledgers and the control account and the internal control relating to the entries in such ledgers, it then became necessary to inquire into the procedures within the accounts-receivable department itself and such inquiries developed information regarding the soundness of the procedures relating to periodical statements to customers, the investigation made of differences reported by customers, collection efforts, bad-debt write-offs, preparation of periodical trial balances, and comparison of such trial balances with the balance in the general ledger controlling account, etc.

The same procedure as indicated for accounts receivable was carried out for all phases of the system of internal control which would include inventories, properties, accounts payable, etc.

During the course of the inquiries, minor employees participating in the procedures were interviewed. In interviewing minor employees they were questioned as to possible departures from standard procedures because in exceptional cases, it would be quite possible that the documents examined would fail to disclose that such *departures* had been made.

Information obtained by interviewing officials and employees of the company was confirmed by actual observation and, in so far as possible, by test checks made of selected transactions.

The internal-audit program and the internal auditor's reports were studied after the inquiries had been completed in order to form an opinion as to the proper functioning of that department.

Accounting forms frequently give an indication of the flow and nature of the procedures to be carried out, and for this reason inquiry regarding the forms in use and inspection of the principal forms supplemented the general-procedure inquiries. It should be borne in mind, however, that the forms primarily serve the purpose of (1) recording phases of a transaction, (2) conveying information regarding the transaction to other departments interested in or participating in carrying out the various steps involved in the transaction, and (3) fixing responsibility for the various steps carried out. In addition to the inspection of accounting forms, inquiries were made as to the types of reports prepared periodically by the various departments of the business for submission to the management. The distribution of these reports was inquired into and the reports were generally reviewed to determine the extent to which the management was being furnished with details of the transactions.

The working papers relating to the audit of the various phases of the system of internal control included a *memorandum* on the procedures surrounding each phase of the system and was supported by a record of employees interviewed, test checks made to ascertain that the prescribed procedures were being carried out, and the comments as to weaknesses in the system and suggested changes.

The procedure outlined above requires considerable time for the first examination but thereafter does not require much time to keep up, and it will facilitate the test checks of the system of internal control which have to be made during subsequent examinations.

Experiences with the Extended Auditing Procedures for Inventories

BY RALPH B. MAYO

Member, committee on auditing procedure,
American Institute of Accountants

THE PURPOSE here is to take out of the regular day's work in a fairly typical office of practicing certified public accountants in a western city experiences with the additional procedures for auditing inventories. The American Institute of Accountants has adopted the added methods. Let us see how they work in actual practice and what questions arise in their application to a particular case. This study will be narrowed to a consideration of inventories only.

Historically it should be noted that the accounting profession had built up through the years prior to 1938 a set of fairly standard procedures for auditing inventories. Based on such precedent, accountants generally did not feel responsibility for the physical existence of materials and merchandise or a count thereof, at least not to the extent of actually observing the taking of inventories. They did apply various office tests designed to satisfy themselves of the reasonableness of the management's representations as to inventories. In fact, many accountants were so sure they had no responsibility for quantity that they did not consider a qualification in the certificate necessary.

Then there broke on the business horizon several spectacular failures disclosing reprehensible financial practices including gross overstatement of inventories. The public could not understand it and a wave of public sentiment made it clear that investors, bankers, and grantors of credit felt that the independent auditor had more responsibility than he had realized.

In order for the accounting profession to maintain its place as a constructive and essential part of the business fabric it was necessary (1) that there be a clear understanding between the business public and the accountant as to the extent of his responsibilities, (2) that the profession carefully study what steps it could properly take to make its service more effective in its protection of the public interest, and (3) that all the members of the profession move as a body in adopting additional procedures to accomplish this result.

The result was an orderly and thorough study of all the angles of the problem by the American Institute of Accountants and the publishing in May, 1939, of a report entitled "Extensions of Auditing Procedure," by its special committee on auditing procedure. This report outlined as a guide to practicing accountants the additional procedures considered essential in the proper audit of inventories and receivables. At the annual meeting of the Institute in September, 1939, this report as modified was approved. This then may be considered a statement of additional procedures for auditing inventories and accounts receivable, which should be generally accepted.

Briefly sketched, the additional steps for verifying inventories where they are a material factor require (1) that wherever practicable and reasonable the accountant be present at the inventory taking, and (2) that inventories in the hands of public warehouses be confirmed in writing.

At first glance these requirements do not appear particularly drastic or burdensome. Let us observe what questions arise when attempting to apply them to a particular situation.

Problem No. 1
Is Opinion Possible in This Case?

The first case to be cited deals with the basic question whether the accountant must, as a requirement of the new pronouncements, refuse to render an opinion and to publish a certified balance-sheet.

Let us first look at the essential facts in this particular case. The additional generally accepted audit procedures relating to inventories and receivables were carefully explained to the client and an estimate was made of the additional cost of the audit for 1940 over the usual amount required for the regular annual audits which had been made consistently through many years. The type of audit was the customary general audit including a balance-sheet verification and a review of operating accounts for the year. After consideration of the matter the client agreed to permit a sample testing of accounts receivable using the "positive" form. This resulted in replies directly to the accountant from the debtors satisfactorily confirming 49.6 per cent of the dollar value of outstanding accounts receivable appearing on the balance-sheet.

With respect to inventories, the client was unwilling to incur the expense of physical tests under the observation of the accountant and his staff. The client was so thoroughly satisfied personally with the condition of the stock, with the careful methods used in taking and pricing the inventory, and with the safeguards and checks on accuracy provided by the perpetual-inventory records, that he felt the security and satisfaction to be derived from the proposed independent testing of quantities did not justify the added cost. It is a business involving both manufacturing and trading as a principal and the large catalogue covers a wide variety of items.

The balance-sheet contained the following principal items in the relative amounts indicated by the percentage of each to the totals:

RESOURCES	Per Cent
Current resources	
Cash	11
Accounts receivable—customers	15
Inventories of merchandise, raw material, and products	44
Other current resources, including prepaid expenses	2
Total current resources	72
Fixed resources	
Land, buildings, and equipment—at cost less depreciation	28
Total resources	100
LIABILITIES	
Current liabilities	
Accounts payable and accrued items	20
CAPITAL	
Capital stock and surplus	80
Total liabilities and capital	100

It will be observed that inventories represent 44 per cent of the total resources and about 60 per cent of the current resources.

The accountant had served this firm for several years and had become impressed with the conservative policies of the management as evidenced by a constant pressure on the accountant (1) to charge off all receivables where collection could be questioned resulting in substantial recoveries each following year, (2) to take the maximum depreciation rates permissible, and (3) to expense all borderline improvements and replacements. The accountant also felt that satisfactory inventory controls and internal checks were maintained.

Under this situation the accountant was faced with deciding whether he must decline to publish an opinion on the balance-sheet.

At this point it will be helpful to examine the official bulletins and the statements of principles as a guide to answering this question.

The report, "Extensions of Auditing Procedure," on page 4 states:

"The independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, in conformity with generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary. In such circumstances, the independent certified public accountant should limit his report to a statement of his findings and, if appropriate, his reasons for omitting an expression of opinion."

Again on page 9 of this report:

"As previously stated, if such exceptions are sufficiently material to negative the expression of an opinion, the auditor should refrain from giving any opinion at all, although he may render an informative report. . . .

"If physical tests of inventories and/or confirmation of receivables are practicable and reasonable and the auditor has omitted such generally accepted auditing procedure, he should make a clear-cut exception in his report."

Bulletin No. 2 of the Statements on Auditing Procedure, dated December, 1939, deals with a specific case where "Approximately 50 per cent of a client's assets are represented by current assets. Inventories account for 55 per cent of the current assets, . . ." No opportunity was afforded the independent auditor to make physical tests of inventory quantities. The Institute committee expresses its opinion to be that in this case "inventories are a material factor," and that "the exceptions with regard to the scope of the examination are sufficiently material to negative the expression of an opinion, and that, accordingly, the auditor should refrain from expressing one."

It will be noted that inventories in the case under study are 60 per cent of current assets, whereas in the case used in the bulletin inventories were 55 per cent; also that in the instant case inventories are 44 per cent of total assets compared with 27.5 per cent in the other. In other words, inventories were more material and significant relatively in our problem than in the bulletin and yet the Institute committee would permit no opinion in the latter case.

This rule may seem severe and extreme to the accountant who must explain to his client that, although he has published certified balance-sheets for years always with appropriate qualifications, he cannot do so now because of a new statement of principles published by the Institute. It is not surprising that some businessmen may not appreciate the force and meaning of principles stated and standards set by a professional body such as the Institute. Then, too, such protesting businessmen probably can find established accountants including Institute members who will accept the limitations here outlined and still certify the balance-sheet with exceptions properly noted.

So what should the accountant do in this case?

It seems clear that the Institute committee would say that the accountant should not publish an opinion or certify the balance-sheet, no matter how carefully he qualified it. The auditor should limit himself to descriptive comments usually referred to as an "informative report." A sharp difference of opinion arose among the members of the accounting firm as to the course to pursue. All felt satisfied that the inventory was fairly stated but minimum procedures had not been followed. It may be of interest to note that those who felt the client should be served as he expected prevailed to the extent that balance-sheets in usual form were presented, but the wording of the short report was modified to state clearly the limitations and that the balance-sheet was prepared from the books as adjusted. Furthermore, it was realized that vigorous steps must be taken to prevent such a situation another year. This would require educating the client to a realization of the basic reasons for such requirements and the protections thus afforded.

Problem No. 2
Other Methods than Physical Tests

The problem here is whether the "other methods" used for verifying inventories in this particular case were properly used and accepted by the accountant to satisfy himself when "physical tests" did not seem practicable.

This again is a case of annual general audits involving the verification of the balance-sheet and a review of operations. The accountant has served in such an audit for several years and is persuaded that the management policies are conservative and that the internal control of inventories is satisfactory.

It is a business operating a number of relatively small retail outlets scattered over several states. The amount of inventory at any one retail location seldom exceeds $3,000. There are four stock rooms maintained to distribute merchandise to nearby retail stores. At each of these stock rooms the stock on hand is relatively large. Three are located at distant points, but the largest storeroom is at the head office.

Although the client places no limitations upon the scope of audit, the accountant cannot ignore the problem of keeping the cost within appropriate limits. After thorough consideration, the accountant has reached the conclusion that it is not practicable to test physical quantities at a sufficient number of locations to represent a significant proportion of the total dollar value of inventories, and yet it is important that his verification be one which will permit the expression of opinion.

The accountant has selected, as an alternative to the usual physical test, the examination and verification of the records of internal control of inventories maintained by the client. His program calls for thus covering more than half the store locations and substantially more than half of the total dollar value.

This inventory-control procedure, briefly sketched, includes charging each retail store and each stock room, except the head office storeroom, with the retail selling price of all merchandise purchased for or shipped to such points. As to stores, this then is the amount to be accounted for (1) in sales, (2) in shipments out, and (3) in merchandise on hand. The inventories are taken by the store manager, and he can and in several instances has covered shortages by overstating quantities. A staff of traveling representatives is maintained to take periodic actual inventories and thus test the records. Any large or material shortage would, if thus covered, be reflected in an abnormally large inventory, thus attracting the attention of the management and of the accountant to the possibility of fictitious quantities.

The accountant examines such records at retail prices and ascertains that the inventory presented to him extended at retail price reconciles reasonably with the book inventory. He thus satisfies himself that quantities are substantially correct. He has a check against the use of fictitious locations in that cash from sales flows in from each store and, further, there are signed leases covering each.

As to the head office storeroom, the usual practice of physical tests is practicable. It might be added that all inventories, in addition to the retail values discussed, are priced and extended at cost, which is the value used in the balance-sheet. The pricing and mathematical accuracy is tested in the usual manner.

In this case inventories represent 40 per cent of total assets and the head office stock room carries about 30 per cent of the total inventory value. The other 70 per cent is scattered at distant points, and is verified as indicated.

The report, "Extensions of Auditing Procedure," on page 9 states:

"It is the responsibility of the accountant—and one which he cannot escape—to determine the scope of the examination which he should make before giving his opinion on the statements under review. If in his judgment it is not practicable and reasonable in the circumstances of a given engagement to undertake the auditing procedures regarding inventories and/or receivables set forth in this report as generally accepted procedure and he has satisfied himself by other methods regarding such inventories and/or receivables, no useful purpose will be served by requiring an explanation in his report."

This problem raises two questions:

(1) Is this substitute procedure one which would permit an opinion, and (2) Is a qualification or exception required in the certificate?

In the opinion of the writer, the accountant is justified in expressing an opinion in this case. It would be well to add to the program an arrangement for correspondent accountants to observe the taking of the storeroom inventories in the four larger cities. This would not add greatly to the cost, but would cover a larger part of the inventory dollar value.

As to the necessity for a qualification in the certificate, it appears not to be technically required; however, the procedure of audit is so unusual and so far removed from actual contact with physical inventories that some comment in the certificate describing the scope seems desirable.

Conclusion

The real purpose here is to discuss actual situations met in professional practice and thus stimulate thought and interest in the task of making the extended auditing procedures work when applied to specific situations. It is highly desirable that practicing professional accountants meet similar situations in consistent fashion. The goal of higher standards of quality must spring from the united determination of like-minded men.

Case Studies in Auditing Accounts Receivable

By Maurice H. Stans, Chicago, Ill.

Member, American Institute of Accountants

Two years have now elapsed since the accounting profession, through the American Institute of Accountants at its 1939 annual meeting, formally adopted the "Extensions of Auditing Procedure," providing among other things for confirmation of receivables as part of generally accepted audit steps. Previous to that time, accountants in the exercise of their discretion were permitted to rely substantially upon the system of internal check and control of their clients and as a result had seldom included the confirmation of receivables in their audit programs; there were some exceptions, it is true, principally in the case of stockbrokers and other security houses, or in individual instances in which the procedure was adopted to deter or to discover employee dishonesty, but they were decidedly the exceptions rather than the rule.

There were undoubtedly many accountants who felt in 1939, and some who still feel, that the requirements of confirmation as provided by the extensions of procedure may have gone further than was necessary for the development of the profession. There are still many who share what is understood to be the English viewpoint, that confirmation of accounts receivable is unnecessary in the course of an audit, and that the auditor should be sufficiently capable in his work to detect misstatements or overvaluation in the accounts without confirmation. This being the case, it is perhaps well to review some experiences of the last two years along the lines of an inquiry into the application of the procedures and the results which they have secured. In a paper presented at the annual meeting of the Institute in 1940, John A. Lindquist analyzed the attitude of clients under the new audit requirements and expressed the conclusion that with the ordinary run of commercial and industrial companies confirmation of receivables by communication has generally received assent. The case studies and statistics compiled herein are presented to measure what the new procedures have accomplished for accountants in the strengthening of their work and in protecting the extremely great responsibilities which the public expects them to assume.

First of all, the basic rule to the effect that direct communication with the debtor shall be regarded as generally accepted auditing procedure is modified specifically by the words "wherever practicable and reasonable." The definition of these two words will possibly form a subject of research and controversy for some time until the accumulated experience of the profession provides its own definitions. The literature on the subject to date is very meager and the principal clue that is available to us is in statement No. 3 of the committee on auditing procedure, which was released in February, 1940. While that statement dealt principally with the auditing of accounts of department stores, chain stores, and other retailers, it does include the remark that "it is believed that there will be very few cases in commerce and industry as a whole in which the procedures of confirmation cannot be applied, to the extent that will afford such tests as the auditor, in the exercise of his judgment, determines to be reasonable."

An analysis of hundreds of case experiences, covering a wide range of types of business, produces a common pattern that discloses some definite weaknesses in the results being secured under present confirmation methods. For that reason, the case studies which are here considered are in no way unusual, or involve very large or very small audits, but consist of the analysis of ordinary run-of-the-mill cases. They are important individually not for what they established for the auditor, but in what they failed to accomplish.

Case 1

This client owns and operates a chain of retail laundries, consisting of twenty plants located in four states. Its accounts receivable consisted of approximately 10,000 accounts with balances at the audit date, the average of which was about $10 and the maximum of which was less than $250. The total value of the accounts constituted approximately 60 per cent of the current assets and the accountant decided that this was a case for testing by the use of negative confirmation stickers attached to the monthly statements mailed as of the audit date. Negative confirmation forms were attached to 5,000 or 50 per cent of the statements, including all of the larger balances and a random selection of the smaller items, and mailed under the control of the auditor.

The replies which were received are not important here, as most of them were from customers who had paid their bills prior to the receipt of the statement; however, as an illustration of what can happen, the mail brought six checks for the amounts shown on the respective statements, of which four were made payable to the auditors and two were made payable to the client. There were also eleven letters of complaint about the laundry services, claiming adjustments, including one letter from an obviously confused old lady who asked if the auditor wouldn't please do something to find her husband's pink striped shirt.

Case 2

This client is a manufacturer making a rather wide range of metal products. Its accounts receivable at the audit date consisted of approximately 900 accounts, the average of which was about $1,000 and the maximum of which was $40,000, the total outstandings being slightly less than $1,000,000 or about 45 per cent of the current assets. The auditor in this case decided that the relatively large individual balances justified the use of a positive confirmation request and accordingly mailed requests for confirmation to all of the 900 accounts.

The replies which were received consisted of the following:

453 replies which confirmed the account as being correct.

Eleven letters indicating pending complaints or working defects requiring adjustment, none of which, however, was material.

Two letters stating that the salesman had represented that the merchandise in question had been shipped on consignment and not as an open charge.

Two remittances in full for the amount shown on the statements, one customer stating that he could see no reason for his account having been given to a collection agency.

One letter from a customer who stated that upon advice of his attorney it was his policy not to confirm any accounts.

This constituted approximately 50 per cent verification in both dollar amount and number of accounts. The auditors sent second requests and secured acknowledgments covering an additional 5 per cent. An interesting sidelight developed, however, when the client turned over to the auditor a file containing sixteen letters which it had received directly from customers, seven acknowledging the correctness of the accounts and nine expressing claims for allowances or adjustments.

Included among the accounts of this client were two relatively large amounts due from large chain store companies, the balances in each being approximately 4 per cent of the total receivables. When these two companies did not respond to the first and second requests for confirmation the auditor, being in a position to do so, telephoned the controller of each of these companies with the following results:

(a) The first company informed the auditor that it did not make a practice of answering such requests and would not vary from the general procedure in this case.
(b) The second company stated that in order to secure a confirmation it would be necessary for the auditor to send a separate request for confirmation for each unpaid invoice.

Case 3

This client is a commercial factor whose business is the purchasing and collecting of accounts receivable, some with notice to the debtors and some on a non-notification basis. The total receivables at the audit date exceeded $15,000,000 and constituted 85 per cent of the current assets and were equal to three times the net worth of the client. If there is any case in which receivables constitute an important portion of the audit or in which verification is absolutely necessary, this is it, and the auditor decided upon a combination of negative and positive methods as follows:

1. Negative confirmations were sent to 15 per cent of the total number of accounts on a notification basis, these accounts constituting 77 per cent of the total value. The replies which were received involved one per cent of those to whom confirmations were sent but related to 12 per cent of the value of the confirmations mailed. Of these replies, four-fifths involved instances in which cash or returned merchandise was in transit and the balance of one-fifth concerned small interest differences or minor discrepancies which the auditor found no difficulty in reconciling.
2. The accounts on a non-notification basis required special consideration, because the debtors had no knowledge of the ownership of their accounts by the factor. Statements and negative confirmation requests were sent out in these cases over the signature of the manufacturers and dealers who had originally shipped the merchandise, requesting confirmation to the auditors. The replies received were very closely in proportion to those on the notification accounts.
3. At the audit date there were a number of delinquent and written-off accounts which were in the hands of attorneys and collection agencies, or in bankruptcy, reorganization, or liquidation. Positive requests for verification were sent to 30 per cent of the active written off accounts, constituting 74 per cent of the total face amount of such accounts. The confirmation requests were sent to collection agencies, receivers or trustees, attorneys and other parties who the files disclosed were in the possession of the best knowledge with respect to the accounts. Confirmations were received from 71 per cent of the dollar value of those to which requests had been mailed.

Case 4

This client was in the retail coal, grain, and feed business and operated in twenty towns in New England. The auditors felt that this was a situation in which negative confirmations were required and so proposed to the client. The client, however, objected to any type of confirmation or reference to auditors, feeling that the nature of his customers in these small towns was such that a great many misunderstandings might develop as to the financial status of the company and, that, in any event, its customer relations might be impaired. By way of compromise, an arrangement was worked out whereby the client attached its own sticker to each of the monthly statements at the audit date requesting particularly close attention to the individual balances and asking a reply direct to its credit department if the customer found that the statement was incorrect in any way. With each statement the client included a postage guaranteed return envelope addressed to a lock-box in the town in which the client's principal office was located, so that the replies would not be sent to the auditors' New York address. The auditors had sole access to the lock-box and by controlling the mailing of the statements and the replies in the usual manner were able to accomplish their verification program without the customers ever knowing that any inquisitive strangers had been around.

Case 5

This client is a subscription book publisher dealing almost exclusively with retail customers by mail. Its accounts receivable at the audit date included 198,000 outstanding instalment accounts with an average balance of less than $5.00. Believing any kind of confirmation to be impractical, the auditor relied upon a punched-card tabulation of all of the receivables to analyze the payment activity and secured the co-operation of the client to the extent of having its accounting department segregate cash collections for a period of 60 days after the balance-sheet date into collections attributable to accounts receivable at that date and those attributable to subsequently created accounts. Considering the extremely small average balance, the auditor concluded that it would be difficult for the management to manipulate enough accounts to misrepresent the receivables to any great extent and further relied upon an excellent system of internal control which appeared to preclude the possibility of any manipulation of the accounts by employees.

These are five cases, each approached in a different way and degree in verification—one by negative confirmation, one by positive, one by a combination of the two, one by indirect negative forms, and one without confirmation.

Through all these cases, selected because they contain representative conditions, there run these common problems:

1. The matter of deciding the method and extent of confirmation testing that should be employed.
2. The difficulty of securing a satisfactory proportion of confirmation replies.

As to the first, there seems to be a considerable difference in practice among accountants. As to the second, it would be unfortunate if accountants developed a tendency to place too much reliance upon the confirmation procedure, to the exclusion of other audit steps; for if it is the exceptions that are disturbing, reliance upon an unsatisfactory confirmation result may be worse than no confirmation at all.

The major question, then, which suggests itself is this—what constitutes satisfactory verification? In other words, should the profession be satisfied with the results shown by these five cases, if they are typical? And what, if anything, can be done to improve them? To quote from an English accounting publication "If the public is led to believe that the direct communication visualized is part of normal audit procedure, is it likely to be sympathetic if trouble should arise in a case where the auditor in the exercise of his judgment has accomplished only a partial verification?"

To protect himself and, incidentally, his profession, what should the accountant do in the case of the receivables for which no replies are received in positive confirmation? Is it his responsibility to search out some or all of the parties who did not answer the confirmation request, or to what extent should he go back to the records in such cases and attempt to make a more thorough study of the transactions included in the balances in question? Or should he, in the exercise of that characteristic we are accustomed to refer to as conservatism, assume that the fact that the customer fails to reply indicates that the item has some defect about it? To what extent should he send second or third requests? These are the practical questions to be decided in each case. If he is too industrious, he may find himself in a position where his report is unreasonably delayed and his assignment consumes an unreasonable amount of time. Yet his alternative may be to run the risk that a clever defaulter or manipulator, knowing the attitude of certain customers with regard to confirmations, might have selected just such accounts with which to work.

This leads to one further question in the case of the negative confirmations. If positive confirmations are so frequently ignored by the recipients, what assurance is there that the persons receiving statements with "nonreply" stickers attached are paying much attention to them?

Perhaps to a considerable degree the failure of persons to answer confirmation requests is due to an unwillingness to be bound by the acknowledgment in case an error is subsequently discovered. Perhaps indifference is responsible, or perhaps the failure to answer positive requests is due to a lack of understanding of the part which confirmations play in the function of accountants in policing the financial statements of industry. In the case of financial houses who have been using positive confirmation methods for years, the educational process has progressed to the point at which almost 100 per cent confirmation can be expected in the ordinary course. Perhaps the degree of understanding of the average customer of a security house is greater than that of the average customer of a laundry or department store or manufacturer, but in any event it seems evident that much remains to be done in the way of public education regarding the importance of auditing procedures and in particular the confirmation of accounts.

In order that the procedure of accounts-receivable verification by confirmation may be gradually improved, it seems that accountants should follow these steps, among others:

1. Requests for confirmation should, wherever possible, accompany regular periodic customers' statements of a current date so that the items constituting the balances which are to be verified are evident. In other words, the confirmation request should in every case furnish the answer which is desired, making it necessary for the recipient to spend as little time as possible in answering.
2. The accountant, either in his report or in a supplemental communication to his client, should state the statistics as to the confirmations attempted and the replies received.

Of considerably greater importance are these thoughts for the profession as a whole:

1. The profession, through its research activities, should endeavor to extend the literature of case experiences in verification of receivables, to the end

that accountants may be better able to define the areas for positive and for negative confirmations, and to exercise "sharpened judgment in the zone of doubt" as to the extent and time of sampling that is advisable in each individual case.

2. An educational campaign should be undertaken with the general public and with various organizations such as trade associations, chambers of commerce, credit men's associations, stock exchanges, and comptrollers' groups, to popularize the use of confirmations and to impress upon them the importance of attention to both positive and negative confirmation requests. The fact that the accountant is performing a public service should make it easy to convince such organizations that confirmation requests are not entirely a nuisance but are an important business function.
3. Methods of simplifying the problem of securing confirmation from chain stores and nationwide companies should be explored by representatives of the profession, in order to work out uniform and essentially simple measures for verifying such accounts.
4. Standard forms should be adopted for both positive and negative confirmations and used by all accountants in order to make it as easy as possible for the recipients to understand and answer. The positive form could provide perhaps for the mere signing of a copy of the confirmation request. The adoption of these standard forms could furnish an occasion for the publicizing suggested under the second point.

There may not be unanimity among accountants on proposals such as these. Consideration of them may lead to the development of other ideas which are more feasible. The fact remains that present results leave much to be desired if accountants are to assume the responsibility the public expects them to assume in connection with receivables.

Auditors' Reports or Certificates

By Frank Ahlforth, Chicago, Ill.

Member, American Institute of Accountants

During the past year it has become apparent that there is some confusion in the minds of those who receive auditors' reports as to the meaning and purpose of such reports. This confusion is best indicated by certain publications, widely distributed, which have failed to distinguish between the various types of auditors' reports. The authors apparently are under the impression that the only report an auditor issues is the short form, or certificate.

The purpose of this paper is to discuss the different types of auditors' reports which, generally, fall into two classes, namely, the short-form report and the detailed or commentary report.

The short form of report usually seen in printed annual reports of corporations is the standard form recommended by the American Institute of Accountants. A standard form was first recommended by the Institute in 1934 and was widely adopted by the profession at that time. Developments in the five years following indicated need for revision and in October, 1939, the revised standard form now in general use was recommended by the Institute.

The revised standard short form of report met the requirements of the Securities and Exchange Commission at the time of its adoption. However, on February 5, 1941, the Commission published amendments to Rule 2.02 of

Regulation S-X, which rule deals with the content of auditors' certificates. These amendments required that additional representations be made by the auditor in certifying financial statements to be filed with the Commission. The Institute's committee on auditing procedure, in statements numbered 5 and 6 dated February and March, 1941, respectively, discuss in detail the revised Rule 2.02. It is indicated in such statements, and we know from subsequent experience, that a certificate will be acceptable to the Commission in a normal case if it takes the following form:

"We have examined the balance-sheet of the XYZ Company as of February 28, 1941, and the statements of income and surplus for the fiscal year then ended; have reviewed the system of internal control and the accounting procedures of the company and, without making a detailed audit of the transactions, have examined or tested accounting records of the company and other supporting evidence, by methods and to the extent we deemed appropriate. Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and included all procedures which we considered necessary.

"In our opinion, the accompanying balance-sheet and related statements of income and surplus present fairly the position of the XYZ Company at February 28, 1941, and the results of its operations for the fiscal year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year."

The suggested form is identical with that recommended by the Institute in October, 1939, except that the following sentence has been added to the first paragraph which deals with the scope of examination: "Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and included all procedures which we considered necessary."

It is apparent from the quoted certificate that the short-form report is simply a brief statement of the nature and scope of the examination made and an expression of opinion as to the financial statements.

So much for the short-form report — now let us consider the detailed or commentary report. The commentary report is written for the information of management, bankers and other credit grantors and, in general, for anyone interested in details of the procedures followed by the auditor and information as to the content of the accounts. It is customary to comment on every item of importance in the balance-sheet and, in many cases, where it is practicable to do so, to explain the major changes in the income account as compared with the previous year or years. The commentary report gives the auditor full opportunity to explain the testing or sampling that he has done and to present information that will be interesting and useful to management and creditors, present or prospective.

The New York Credit Men's Association has issued a booklet entitled "Financial Statements—Minimum Requirements for Credit Purposes." The date of issuance is not clear, but it contains certain matter dated in May and July of 1940, and I think it came to my attention sometime during the latter part of that year.

The foreword to the booklet says in part:

"So far as investors in publicly owned corporations are concerned, we believe that the short form of report may be adequate. The average investor is not an analyst. He may wish to rely on the short form as evidence of an audit which has been conducted in accordance with recognized accounting principles.

"It must be noted, however, that credit grantors are in a different position. They have come to the conclusion that a detailed statement by the accountants, setting forth what work was done in connection with the audit, is essential to intelligent credit analysis. It is not sufficient for the credit grantor to assume that certain things have been done as indicated by the short form. The soundness of his judgment is vitally affected by factual information in connection with audit procedure; he cannot accept a blanket expression of opinion."

The booklet indicates certain minimum audit requirements, none of which are unusual except that the auditor is requested to verify all payables (notes, trade acceptances, accounts, etc.) by direct communication. The Institute's booklet "Examination of Financial Statements by Independent Public Accountants" does not request confirmation of accounts payable unless an account appears to be irregular.

The foreword quoted above agrees with what I have been saying to the effect that the commentary report is needed for information to credit grantors, but it is surprising to hear that this association of credit men has just now come to this conclusion. The implication is strong that detailed reports have not been available in the past. Detailed or commentary reports have been written by auditors almost if not from the beginning of the practice of public accounting in this country, and if credit men have not received them it would seem to be because they have not made their wants known to the borrower.

Probably the most complete indication of the views of credit men on audits and audit reports is found in the brochure entitled "The Balance Sheet of the Future" by Roy A. Foulke, of Dun and Bradstreet, Inc.

This pamphlet sums up briefly but interestingly the early history of accounting in this country, beginning with colonial days in 1710, points out evolution of accounting principles, creation of standards by the New York Stock Exchange and the growth in interest in accountancy through the unusual situations which have developed in the last few years.

The booklet cites sixteen points in a questionnaire which was sent to four groups of individuals located in all parts of the country, namely, bank loaning officers, financial executives of larger industrial and commercial corporations, mercantile credit men and accountants. Fifteen hundred questionnaires were mailed to each group.

Of the sixteen points, five were questions regarding the balance-sheet, three referred to inventory, one on investments, three on deferred liabilities, one on surplus account, two on the certificate and one on the responsibility of the accountant.

Although the questions are propounded by a credit man, many of the items indicate that the short-form report or certificate is the only report the auditor makes and that no other detailed information is available emanating from the auditor when financial statements are prepared for credit purposes. This, in spite of the fact that the commentary type of report has been in use for many years and is usually recommended by accountants where analysis for credit purposes is desired.

Of the sixteen points, I will quote only one which deals with the auditors' certificate:

"Do you think the certificate should state in detail the scope of the work done in connection with an assignment? At present identical clauses are used by different accounting firms but the scope of examination or audit made by each may not be the same. In other words, do you think the certificate should disclose all limitations of an engagement or in carrying out an assignment?"

The information asked for will usually be found in satisfactory form in the commentary type of report. No less than six of the other questions were of a nature that indicated that no recognition had been given to the well known fact that auditors' reports are of at least two different types.

Without meaning to be critical of the

questionnaire, I would like to suggest that better and more constructive results would have been obtained if approval of the American Institute of Accountants had been obtained as to the form and content of the questions before they were published.

Different Reports on the Same Engagement

In speaking of different reports on the same engagement, I mean only that the reports are different as to type.

The commentary report which follows the short-form report on the same examination must not be used as a means of qualifying items which were unqualified in the short-form report. It must not be used to disclose material facts which were not disclosed in the short-form report or in the accounts attached thereto. It must be used only to furnish explanatory details regarding the scope of the examination, and the content of the financial statements. D. L. Trouant says in his book *Financial Audits* that some of the matters most frequently covered by a good detailed report include:

Scope of the examination, including a record of the companies whose accounts were examined.
Summary of major changes in properties, investments or corporate structure.
Results of operations for the period, comparison with previous period and explanations of important changes.
Changes in financial position, perhaps in the form of a summary statement of resources provided and applied.
Analyses of and comments on important balance-sheet accounts.

Unfortunately, there is at least one recent case of record wherein auditors are said to have failed to disclose material facts in reports to security holders, although the commentary report on the same examination contained complete and accurate explanation of such material items.

In the proceeding of the Securities and Exchange Commission in the *A. Hollander & Son, Inc.*, matter, as reported in a release dated February 6, 1941, the Commission draws attention to an amount of $350,000 owing by a syndicate to the Hollander Company. The release states that the Hollander Company balance-sheet included, without segregation, $150,000 of $350,000 among "notes receivable" (trade); the remaining $200,000 was included among "loans receivable." The Commission found "that the $150,000 included in the item 'notes receivable' (trade) was not accurately described, for the item was in no sense a trade note." The Commission also found that it was materially misleading to include the $200,000 advance among "loans receivable" without some explanation of the origin of the obligation. The Commission stated it was significant that, although these items were described as indicated in the balance-sheet, which was a matter of public record, the audit report for the related year prepared by the auditors for private distribution to the Hollander management and to banks and other financial institutions, but not made available to the public security holders of Hollander, contained a complete and accurate description of the indebtedness of the syndicate to the registrant.

There is another case which, while it is of a different nature, may serve to illustrate the danger inherent in different reports on the same engagement. I refer to the *State Street* case as reviewed by James L. Dohr in the September, 1940, issue of *The Journal of Accountancy*. Here the majority opinion by Judge Finch of the New York Court of Appeals appears to be influenced, among other things, by the fact that the detailed report was not sent to the client until thirty days after the certified balance-sheet was delivered. However, the Judge conceded that the certified balance-sheet and the balance-sheet contained in the detailed report were substantially identical.

Mr. Dohr says:

"Judge Finch appears to have completely misunderstood the significance of the condensed statement and the accountants' report. Accountants customarily issue a certified balance-sheet in advance of their full report. This is what happened in the instant case, and the balance-sheet in the report was, as indicated above, for all practical purposes identical with that of the condensed statement. The record is barren of any evidence that the full report was withheld deliberately; that any time was 'allowed' to elapse before filing it; that any information was 'suppressed'; or that there was any 'active misrepresentation.' Since Judge Finch was mistaken in this connection and since he relied largely upon this evidence for his 'inference of fraud,' his case collapses when the facts are properly understood."

My comments and quotations should not be regarded as a review of the *State Street* case. I have touched upon only one point which I used to illustrate the inherent danger of writing different reports on the same engagement. In the case referred to, according to Mr. Dohr, there was no practical difference. But if there had been, the auditor would have had no effective defense.

Auditors' Reports

BY A. S. FEDDE, NEW YORK

President, New York State Society of Certified Public Accountants; member, American Institute of Accountants

IN DISCUSSING this subject I shall refer to the reports made by the independent certified public accountant on the audit of accounts, and not to reports on other types of engagement.

The very large corporations are generally so well staffed that comparative statistical and financial data are continuously being assembled and presented to the officers. In such cases the concerns may have no use for detailed reports by the auditors, but wish only a short report or certificate to present with the financial statements to their stockholders. Under those circumstances merely a short form of report is submitted unless the auditors feel that some further information will be useful to the management or the accounting department or, from their point of view, should be presented for some special reason.

In the case of concerns not so competently staffed, which may also include some of the large companies, it is customary for the auditor to present a detailed report on his engagement covering such matters as he believes to be important or useful. This report generally includes pertinent facts regarding the operations, new funds made available and their disposition, the position of the company, comparative figures, explanations regarding certain items in the statements and, in many cases, it includes a statement of the more important procedures connected with substantiating the balance-sheet items. Informative and constructive comments are in most cases welcome, but great care is required in the writing of that type of report lest the auditor adopt the tone of a controller and inadvertently state as fact matters which he, as independent accountant, has not substantiated by audit procedure.

Those matters which have for some

time been under discussion in formulating an acceptable type of short-form report are equally applicable to the detailed report, such as, precision in statement of the scope of the engagement; avoidance of overstatement of what has been done; inclusion of any material qualifications; an assurance of consistency in the application of proper accounting principles; and an opinion upon the fairness of the financial statements if such opinion is warranted.

Reports for Credit Purposes

Credit grantors have not been backward about presenting criticism or objections to reports of accountants, but there is by no means unanimity as to what they desire. Some bank credit men have expressed a preference for the short form, but objected to that formerly in use. I believe that most of their wishes have been met in the new form. However, the number that prefer only a short form, while representing some of the larger banks, are, I believe, in the minority. The majority of bank credit men want as full reports as they can get, from which they expect to form an opinion both as to the quality of the accountant's work and the credit risk. It is not difficult to satisfy them where the client is willing that the credit men have in their files all the information about their business that appears in detailed reports on an audit engagement; but very often the accountant's client does not wish such information to be in the files of credit grantors where possibly it may, through exchange of credit information, come into the possession of business rivals.

The differences between credit men and the accountants have mainly arisen from the desire of credit grantors that the pressure on the client to furnish them with detailed information should be applied by the accountant; or from their belief that the accountant should furnish them with requested information as a matter of course, whether or not they had permission from the client to do so.

Members of the accounting profession have for many years maintained that they would gladly afford to credit grantors any information in their possession that their clients were willing that the credit grantors should have.

Interim Reports

The accountant's engagement may be for a year-end audit, or for a continuous audit with a report only at the close of the fiscal period, but often he is required to report at more frequent intervals, and he must determine the type of report to make. At such interim periods he will have employed usual audit procedures with respect to a portion of the records but probably will not have confirmed accounts receivable, or inspected the taking of physical inventories, or employed other procedures which, under the terms of his engagement, he could only undertake once a year.

In such cases where audit procedures have not been applied to all substantial or important items, the interim report should be qualified, even though the accountant believes the items are in order, because he has not as a professional person performed the functions which he is bound to carry out before he can render an opinion. Where the reports are not to be presented to outsiders, the client may not object to receiving the statements and such informative data as may be appropriate, without the expression of an opinion, and containing a clause in the report to the effect that at interim audits (or examinations) some of the procedures customarily undertaken only at a closing date have not been employed and it is understood that the report is submitted mainly for management purposes.

However, a different situation arises where the management wishes the report for exhibition to outsiders for credit or other purposes. If the concern is still willing to accept the report in the form just mentioned, well and good. No reader should be misled when the report states that, while the accountant has been engaged on interim work, the examination has not been complete, and it does not contain an expression of opinion—at least not an unqualified one—on the statements, and does limit the purpose for which it has been prepared.

If the concern wishes the report for credit purposes and wants an unqualified opinion, the accountant must satisfy himself, by audit procedures, of the fairness of the statements. Perhaps the accountant has done all the work necessary in connection with a closing-date statement with exception of confirming accounts and substantiating a physical inventory in accordance with the recently adopted practice. Where this work has been done fairly recently, even though not at the statement date, and the billing, credit, and collection departments function efficiently, and a good system of perpetual-inventory records is operated, and no unusual circumstances exist to provoke the interest of the accountant, then I believe he could issue the usual short form of report, though inserting the words "at such times" in the phrase "by methods and to the extent we deemed appropriate," so it would read "by methods, at such times, and to the extent we deemed appropriate." However, I believe further information should be given in the circumstance where such tests of receivables and inventories, even though quite recent, were made in a prior period and not in the period covered by the report. I quote a paragraph placed between the opening and closing paragraphs of a standard short form-report issued on the accounts of a company during this year.

"Accounts receivable were confirmed toward the close of 1940 by communication with the debtors, and at the same time we attended the taking of physical inventories and made such tests as we deemed appropriate. Based upon those examinations and other tests made subsequently, it is our opinion that accounts receivable and inventories are fairly stated at March 31, 1941. Federal income and excess-profits taxes are accrued to March 31, 1941, at rates in effect for the year 1940, and an additional amount reserved for expected federal tax increase."

The example shows what is relied upon and the accountant, in effect, states that the circumstances are such that they do not negative his right to an opinion.

Report or Statements without Audit

The question of letterhead or no letterhead seems to be a perennial one in connection with the presentation of balance-sheets and income statements that have not been audited. I do not believe anyone will dispute that, if such statements are enclosed in the regular cover for reports, the least requirement is that each statement be clearly and conspicuously labeled that it has not been audited. It is good practice to have such statements prepared on plain paper and fastened to a plain back. A letter of transmittal could be sent with them, but not attached to the statements, with such information as may be required but carrying a reference to the statements as having been prepared without audit. If the client were to attach the letter to a set of the statements the accountant would be protected by his reference in the letter to the absence of audit. I do not think that we should be called upon to go further than that.

You are probably familiar with the resolution adopted by the Society of Louisiana Certified Public Accountants which was published in January of this year. It reads:

"Resolved, That the practice of a certified public accountant in reporting on financial statements under his signature, or on his official letterhead, when such statements are merely a transcript of the books, even though the report clearly states that the statement is a transcript of the books without verification of the assets and liabilities, is misleading, and is condemned, as being detrimental to the best interest of the profession and the public which it serves."

This refers to "financial statements" without any designation as to the kind of financial statements and makes no exceptions, and apparently also applies to an unattached letter if it contains any "reporting on financial statements." It also flatly states that the practice the resolution condemns "is misleading." Is such characterization warranted?

In a recent patent-suit case an accountant had been asked to prepare some analyses and summaries from statements supplied to him. This he did with appropriate explanations and with a disclaimer that he had made any examination or even seen the books. The attorney in court repeatedly referred to the document as "the auditor's report." He would probably have done so even if it had been on plain paper.

We are subject to certain sections of the education laws, to restrictions imposed by regulations of the Securities and Exchange Commission, to our own codes of ethics, and to our self-imposed standards for examinations of financial statements. It is easier to get into a strait jacket than to get out of one, and the fewer set rules we adopt the more freedom will we have to act as professional men doing what is necessary according to the requirements set by circumstances and by the standards set in good practice.

Model Short Form of Report

The original wording of the present short form of report prepared in connection with the booklet, "Extensions of Auditing Procedure," was adopted September 19, 1939. The Securities and Exchange Commission made effective on March 1, 1941, amendments to rule 2-02 of Regulations S-X and, following some discussions, our committee on auditing procedure came to an agreement regarding the wording of an additional phrase acceptable to the S.E.C. in view of the clauses in its rule (b)(ii) and (iii). The agreed upon sentence is added to the first paragraph of the short form report and, as published in "Statements on Auditing Procedure," Bulletins No. 5 and No. 6, is as follows:

"Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and included all procedures which we considered necessary."

It is not claimed that the present model for a short form of report is applicable or should be used following all audit engagements, or that a final perfect form has been evolved. Indeed, there always will be room for improvement. Let me touch upon two matters in this connection.

The word "examined" is used instead of the old familiar word, "audit," because it is thought the public connects the latter word with the idea of a detailed examination covering all transactions. That may be so, and I approve of anything that will clarify our position and our work in the public mind. It is well to remember, however, that we still audit, even though in the case of concerns employing good internal checks our auditing procedures may be abridged. In the report of the committee on terminology issued May, 1941, in Accounting Research Bulletin No. 9, "audit" is used as a generic term, and a subdivision is given to defining what is generally called "examination," which reads as follows:

"An examination intended to serve as a basis for an expression of opinion regarding the fairness, consistency and conformity with accepted accounting principles, of statements prepared by a corporation or other entity for publication—in this sense more generally called 'examination.'"

In the revision of Rule 2-02 of the S.E.C. previously referred to, under paragraph (b) "Representations as to audit," reference occurs frequently to audit, auditing, and auditors, and concludes with the paragraph:

"Nothing in this rule shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required by paragraph (c) of this rule."

In the model short form of report expression is given, briefly, to the nature and scope of the work done, so any reader should be on notice that the auditing was done, more or less, by tests. If a client should indicate preference for the term audit instead of examination I see no good reason for not employing it.

Then there is the negative clause "without making a detailed audit of transactions," which is unnecessary in view of the affirmative and limiting statements. It sounds like an apology for having omitted something that should have been done. It is less objectionable than the phrase used in the previous form, but it still sounds apologetic.

But even without the improvements that the future will bring, the present form of report, including the new sentence required therein by the S.E.C., is rich in substance as can be seen by its contents, which may be subdivided as:

1. Recital of financial statements examined.
2. Statement of review of internal control.
3. Statement of review of accounting procedures.
4. Disclaimer of having made detailed audit.
5. Assertion of having examined or tested records.
6. Assertion of having examined or tested other supporting evidence.
7. Assertion of use of own judgment in the methods employed.
8. Assertion of use of own judgment in the extent of the work.
9. Reference to auditing standards.
10. Reference to the inclusion of the necessary procedures.
11. Opinion as to fairness of the statements.
12. Opinion as to their conformity to accepted principles.
13. Opinion as to consistency with the preceding year.

It is a considerable accomplishment to embody thirteen points in so short a form of report. But the future will inevitably bring changes. I offer my suggestion of an altered construction in the following:

Board of Directors (or Stockholders) of
the XYZ Company:

We have examined the balance-sheet of the XYZ Company of April 30, 1939, and the statements of income and surplus for the fiscal year which ended on that date. In our examination we reviewed the system of internal control and the accounting procedures of the company, and examined or tested accounting records of the company and other supporting evidence by methods and to the extent we deemed appropriate. Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and included all procedures which we considered necessary.

In our opinion, the accompanying balance-sheet and related statements of income and surplus fairly present the position of the XYZ Company at April 30, 1939, and the results of its operations for the fiscal year, in conformity with generally accepted accounting principles which have been applied on a basis consistent with that of the preceding year.

We have for so long been accustomed to mentioning the statements first and the company's affairs thereafter, that I wonder if any thought has ever been given to transposing them. If they were so transposed my opinion paragraph would read as follows:

In our opinion, the position of the XYZ Company at April 30, 1939, and the results of its operations for the fiscal year are fairly presented in the accompanying balance-sheet and related statements of income and surplus, in conformity with generally accepted accounting principles which have been applied on a basis consistent with that of the preceding year.

Since what we do in making a year-end examination is an audit, though of a type depending on circumstances, we should not try to discard a term which has become so thoroughly identified with one of our major functions. I therefore suggest that with the model form of report it should be considered optional to use the terms "audited" and "audit" in place of "examined" and "examination."

Appointment of Auditors

BY JOEL M. BOWLBY, CHICAGO, ILL.
Member of council, American Institute of Accountants

I HAVE been asked to present, for discussion from the floor, a résumé of the arguments for and against the election of independent auditors by stockholders, by the entire board of directors, by a committee of nonoperating directors, or by the management.

I do not know just how long this matter has been under discussion by the profession. *The Journal of Accountancy* for April, 1925, contains comment upon the subject and states that it had been the subject of comment for many years theretofore. All of the early commentators vigorously supported the theory that election should be by stockholders, although the article referred to above does admit that while "sometimes it seems as though there were an increasing tendency on the part of stockholders to participate in the conduct of business, those indications usually fade away, and we relapse into the condition of acquiescence which has been the custom of the past."

In a somewhat later issue, which compares the "shareholder" method and the "director" method, it is argued that:

"In the one case, therefore, the true owners select their independent investigator, who might almost be called an arbiter, and in the other case the directors select one whom they deem competent to perform the same service, but with this marked difference, that they who are merely an elected board of management make the selection of a person or persons who will investigate what they have done and *will receive the required fees from them.*"

I call your particular attention to the stress laid upon the "*fees.*"

These arguments undoubtedly influenced the thinking of the times. A resolution adopted by the Chamber of Commerce of the State of New York on June 2, 1932, advocated the election of auditors by shareholders; and the Pennsylvania Corporation Code, enacted in 1933, provided that: "unless the by-laws expressedly provide otherwise, all such (financial) reports shall be certified by an auditor elected by the shareholders of the corporation." An editorial in the August, 1933, issue of *The Journal*, in commenting upon these "advancements," contained the following:

"In brief, the chief merit of election by shareholders is the totally independent status which such a method of selection implies. We all know that a reputable accountant is not supposed to be swayed in any way by the fact that he owes his appointment to a group of directors. He is supposed to express a fair and impartial opinion without thinking for a moment of the source of his engagement. Probably in ninety-nine cases out of a hundred the auditor is able to detach himself entirely from any question of obligation except an obligation to the cause of truth. But, when all is said and done, the auditor is human and he cannot always be expected to forget that it may seem perhaps a little ungracious to indulge in condemnation of the administration of a corporation when its administrators are his direct clients. If employed by shareholders he stands entirely independent of any influence and he can, without doubt, more freely express his views than he could if he were the chosen appointee of the men whose administration he was called upon to criticize either favorably or adversely."

One of the closing arguments in this historical review was to the effect that "it is bad enough to have the directors appoint the auditors, because the directors themselves are the agents appointed by the owners to carry on the business."

These expressions all appeared during the period from 1932 to 1934, inclusive. Thereafter there is quite a hiatus and little if anything appears on the subject until 1938, when a change of attitude begins to make its appearance. In that year, an article, commenting upon the aforementioned resolution of the Chamber of Commerce of the State of New York and the relative provisions of the Pennsylvania Corporation Code of 1933, states with respect to election of auditors by stockholders:

"This practice seems entirely commendable and adverse to the interests of none, but in all fairness it should not be proclaimed as a panacea. There is perhaps a danger that some persons of more imagination than experience might seize upon this administrative device as a 'reform' designed to correct all sorts of alleged weaknesses in corporation management. If adopted in this spirit, the 'reform' might prove disappointing. Its immediate visible effect might be very slight. In spite of rumors of venality which have become fashionable, accountants know that corporations whose securities are publicly held are generally managed in the best interests of stockholders. It can also be safely asserted that certified public accountants acting as auditors of such corporations, realizing clearly that their chief strength is their reputation for complete independence, will not permit encroachment on that independence, regardless of who employs them."

Eminent spokesmen for the profession are constantly impressing upon the public that accountancy is not static but is in a process of constant development. The comments which I have just quoted are only a further evidence of that development.

I have no hesitancy in saying that no inflexible rule should be laid down for the selection of the independent auditor of any corporation. The management may constitute the majority of the board of directors, but may also be or represent substantial stockholders. In such case, in my opinion, all requirements are met in appointment by the management. In another case, the management may constitute the majority of the board, but may not own or represent a substantial stock interest. In this case, it would seem preferable that the auditor be selected by a committee of those directors not directly concerned with the ordinary duties of management. Again, management may constitute only a minority of the board, the other members being or representing substantial stockholders. Here there seems to be no reason why the appointment should not be made by the board of directors. Only in the rather extreme instance of the board of directors being composed of men who are not to any material degree financially interested in the operation of the company, does it seem necessary that election by shareholders be required.

I can see many reasons why election by shareholders is undesirable. We of the profession know that many firms are peculiarly qualified in certain lines of business and these qualifications are not generally known to the shareholders. Again, we know the value to a corporation of auditors who, through long association, have acquired familiarity with its operating, patent, fiscal, tax and other problems. This value should not be destroyed at the whim of some stockholder, regardless of the importance of his holdings and his influence upon other shareholders.

Now, in conclusion, I want to leave with you the thought expressed by one of the expert witnesses at the public hearings called by the Securities and Exchange Commission in its investigation of accounting questions arising from the much discussed McKesson & Robbins case. A former president of the Institute and one of my recent and well beloved partners said: "I think an auditor's primary responsibility runs to his own conscience, to his firm and to his partners as necessitating a thorough and independent investigation on his part with as dispassionate display as possible." If that responsibility be recognized by our profession, and I would be the last to admit that it is not so generally recognized, then the method of selection of independent auditors is relatively unimportant.

II

Federal Taxes

Chairman: J. A. PHILLIPS *September 17, 1941*

Introduction

BY J. A. PHILLIPS, HOUSTON, TEXAS
Member, committee on federal taxation,
American Institute of Accountants

THE tax sessions of our annual meetings have become most important. The session we are now opening has been arranged to bring to you timely discussion of administrative and legislative problems in respect of federal taxation. It brings to you six speakers—each, with one exception, a twenty-minutes man. Five of our speakers are well known tax practitioners, and members of the American Institute of Accountants. Our other speaker is a representative of the Treasury Department (Assistant Legislative Counsel), and in his case we deem it appropriate to grant an extension of time.

During the first half of the current year, the committee on federal taxation actively engaged in the dissemination of helpful information in respect of the excess-profits-tax law, and continued its coöperation with the Treasury Department and its coöperation with other organizations. During the last half of the current year, the principal activities of the committee have related to legislation. Its report has been mimeographed and filed with council, and a separate report has been compiled and submitted in which numerous changes in the law are recommended. The latter report deals primarily with technical and procedural matters. Members of the committee have been active, energetic, and helpful, but the work of the chairman, Walter A. Cooper, has been truly outstanding.

Just a word with respect to legislation. Under the new high levies, what is to happen to taxpayers that are under heavy debt-retirement programs? It seems to me that relief should be provided for taxpayers that were heavily indebted on the effective date of the 1941 act. There are many instances where taxpayers have incurred indebtedness for various purposes, relying upon projected earnings, and have scheduled maturities of such indebtedness so that the taxpayer could "pay out," so to speak, on the basis of the forecasted earnings. In projecting (or estimating) earnings, many such taxpayers did not anticipate that such a large portion of the earnings would be consumed in the payment of income and excess-profits taxes, and hence in their projections such an excessive requirement was not provided for. The result is that the earnings of these taxpayers will not permit them to retire their outstanding indebtedness and at the same time meet the liability for the increased taxes. This is particularly true in some sections of the country with respect to oil companies and other businesses with depletable or highly depreciable properties.

In order to alleviate this condition and make it possible for such taxpayers to continue in business, it seems necessary that some relief provision be enacted whereby taxpayers, which are required to use a large portion of their income to retire indebtedness incurred prior to the passage of the act, be permitted some credit in the computation of their tax liability. Manifestly, such taxpayers cannot use an income dollar both to retire a dollar debt and a heavy tax liability. If relief is not granted, many small corporations will pass out of existence and the taxes which they would otherwise pay will be lost entirely.

In respect of administration—it is my belief that the administrative officials in the Bureau of Internal Revenue are, by and large, attempting to find the right answers and the right procedures. However, it appears that some employees of the Bureau, particularly some examining agents, are placing improper emphasis on language from the courts such as "pierce the veil" and "by which the fruits are attributable to a different tree from that on which they grew."

In a recent case, an examining agent not only identified the tree that bore the fruit—he sought to change the fruit to another kind, in order to obtain a greater yield for the Treasury at the expense of the grower—the taxpayer. In the case referred to, the taxpayer owned preferred stock in a corporation. Having notice that the stock he owned would be retired, he sold it to obtain the benefit of the capital net-gain provisions. The examining agent said that the fruit representing profit "should be taxed as a partial liquidation instead of a capital gain."

In another case, the taxpayer sold fee lands together with the minerals, reserving a royalty interest. The examining agent held that the lands involved in the transaction were sold, but as to the minerals, only a lease had been executed—holding that the fruit was bonus instead of a capital gain.

It is submitted that court decisions are based upon considered facts in each case. Examining agents are going a little far when they attempt to apply the effect of a decision to a set of facts differing entirely from the facts considered by the court. It is still the function of the courts to fit decisions to their findings of facts.

The Revenue Act of 1941

BY STANLEY S. SURREY, WASHINGTON, D. C.

Assistant Legislative Counsel, Treasury Department

I APPRECIATE very much the opportunity to become acquainted with those members of the Institute who are interested in taxation. To date my acquaintance with the Institute has largely been through the present chairman of your committee on federal taxation, and through the reports of that committee. Both have kept us very busy—and for the same reason. The constructive suggestions and criticisms which the chairman has many times given us in person, and which the written reports always contain, are a constant and stimulating challenge. Your committee deserves real praise for its success in keeping its work on a high level as respects both technical ability and range of comment.

The topic I have chosen is a description of the revenue act of 1941. Its choice requires an explanation. I know that you gentlemen are profoundly interested in the large and vital problems of tax policy that we are facing today—the amount of revenue that taxes must raise in the ensuing years, the rôle that taxes must occupy in combating inflation and in assisting priorities to concentrate on defense production, the changes in our existing taxes and the kinds of new taxes that we must seek to achieve these objectives, and so on. But I fear that this field is so vast and unexplored that an attempt to chart it in half an hour would not prove fruitful—and besides, a lawyer is not the trained explorer that one needs to guide such an expedition. Consequently, I have thought I could best be of service to you by limiting myself to a description, largely on the technical side, of the contents of the revenue measure which has just cleared the Congress. Perhaps the other speakers will be able to help you juggle the stupendous figures, tax-wise, respecting this bill—3½ billions of dollars in additional revenue, an estimated 13½ billions in total revenue, of which 9 billions will come from the income taxes.

We may begin with the individual-income tax. The two most important substantive changes in this tax are the lowering of the personal exemptions to $750 and $1,500 and the increase in the surtax rates together with the lowering of the surtax brackets. The lowering of the exemptions is responsible for an interesting innovation which will have important consequences—that of the new simple return for low-income taxpayers. This form of return is optional with taxpayers having a gross income of $3,000 or less, provided that the income is derived entirely from compensation for personal services, dividends, interest, rent, annuities or royalties. A taxpayer electing this return need only spot his gross income on the table printed on the return (the gross incomes being ranged in blocks of $25 each) and pay the tax opposite that income. (I am sure that this is only of academic interest to you gentlemen—what you really want is probably such a simple return for General Motors or United States Steel.) The tax amounts in the table were computed on this basis: The tax that would otherwise be due on the gross income was computed, taking into account the normal and surtax rates, the earned-income credit and the personal exemption; and then from this figure was subtracted 10 per cent of that amount. The remaining amount constitutes the tax. The 10-per-cent subtraction, which is close to the average amount of deductions taken by taxpayers in this group, is, of course, a substitute for the deductions that might be claimed by the taxpayer, so that the tax is on net income and not gross income.

The benefits of this form of return would appear to be as follows: Any time a taxpayer uses this return the Bureau of Internal Revenue is spared the necessity of checking amounts claimed as deductions. The taxpayer who elects to use the return without computing his tax on the regular methods saves the trouble of keeping track of his deductions and of going through the steps, which may appear to be rather complex for this group, in the computation of the tax. The taxpayer who nevertheless determines to ascertain the amount of his tax under the regular method is in a position to obtain either the average amount of deductions for taxpayers of his class or his actual deductions if they exceed the average, as would probably be the case if, for example, the taxpayer was a home owner under a mortgage so as to have a deduction for interest. In advance of actual operation this simple return appears to be a desirable step forward in the difficult field of making the income tax applicable to the low-income groups. Consequently, it will be interesting to observe its efficacy in actual operation.

It should be observed that the Congress did not believe this simple form of return could be made available to taxpayers whose gross income is over $3,000. In the first place, it would be difficult to find an average amount of deductions for this group. More important, however, is the severe revenue loss that would result from such extension. While a slight loss is to be expected from the use of this return in the case of gross incomes under $3,000, this loss is offset by the advantage of simplicity. But extension of this return to incomes over $3,000 would not be productive of simplicity, for such taxpayers, being accustomed to the regular method of computation, would merely figure the tax both ways and select the cheapest method.

The remaining important individual-income-tax changes relate to the method of accounting for income on certain government obligations. Under prior law the increase in the redemption price of noninterest-bearing obligations issued at a discount, such as baby bonds and defense savings bonds, while treated as interest accruing each year to the taxpayer on the accrual method, was taxable in its entirety in the year of redemption in the case of the taxpayer on the cash-receipts basis. Such a taxpayer with a fairly substantial number of these obligations might thus be required to pay a tax greatly in excess of that which would be paid if he were on the accrual method. To avoid this result, which might have had a restraining influence on the sales of these obligations, the new act permits taxpayers on the cash-receipts method to elect to return such increment on the accrual method. Such an election, if one is made, becomes applicable to all such bonds held or thereafter acquired by the taxpayer and is irrevocable unless permission to change is received.

This recognition by the Congress that methods of tax accounting cannot be kept in air-tight separate compartments, but on the contrary must be shaped to meet the exigencies of particular problems is highlighted by the reverse treatment given to Treasury bills. When such bills were made taxable by the public debt act of 1941 there arose the complications of separately calculating accrued interest and short-term capital gain and loss. To avoid this, Congress in this act has provided that the discount on such bills—described as obligations issued by the federal government (the provision also extends to similar state obligations) on a discount basis without interest and with a maturity of not more than one year—shall not be considered to accrue until the obligation is sold or redeemed, and that such bills shall not be considered capital assets. Hence, while the taxpayer on the cash-receipts method is permitted to accrue the increment on noninterest-bearing discount obligations having a maturity of more than one year, the taxpayer on the accrual method when the maturity is less than one year must return the increment on the cash-receipts method.

So much for the individual-income tax. In the field of corporate taxation, we are met with the apparent innovation of a graduated surtax on corporations. As the rates, however, are 6 per cent on the first $25,000 and thereafter a flat 7 per cent, the absence of a material graduation makes inapplicable the recognized arguments against such a tax in the case of corporations. At the same time the existence of some graduation, albeit small, permits the tax to be made applicable to the interest on the outstanding partially tax-exempt federal securities, as they were not issued exempt from surtaxes.

A commendable change in the direction of simplicity in the corporation-income tax, and in the individual-income tax as well, is the permanent integration of the 10-per-cent defense tax rate with the basic rates. In the case of the individual-income tax this is accomplished by keeping the 4-per-cent normal tax and raising the surtax rates to absorb the defense tax. In the corporation tax, the normal tax rates on corporations whose incomes are under $25,000 have become 15, 17, and 19 per cent, on those with incomes over $25,000 the rate is 24 per cent, and the present double notch is eliminated and a single notch substituted. For corporations whose incomes are over $25,000, the combined normal and surtax rates thus in effect total 31 per cent. In the case of the estate and gift taxes, and all of the other taxes where the defense tax was applicable, a similar integration is accomplished.

The latest addition to the income-tax family, the excess-profits tax, in keeping with its heredity and environment, is busily engaged in acquiring new amendments despite the number of changes made earlier in the year. To begin with, the rates of tax have been increased 10 percentage points in each bracket, so that they now run from 35 per cent on the first $20,000 of adjusted excess-profits net income to 60 per cent on the excess over $500,000. Next, the flat 8-per-cent credit under the invested-capital method has been cut to 7 per cent as respects so much of the invested capital as is in excess of $5,000,000.

The next change is more complicated and to many will resemble the magician's white rabbit. Under present law the corporation-income tax is available as a deduction in computing the excess-profits tax. The Congress in the new act simply reversed the process, and made the excess-profits tax a deduction for the purposes of the corporation normal tax and surtax. This bit of juggling has the effect of increasing the yield of the excess-profits tax at the expense of the corporation-income tax, although a considerable net revenue gain is achieved. The change is justifiable, however, on its own merits aside from the revenue effect. Tax rates have increased from an average of, say, 16 per cent, for the base period, to 31 per cent under the new act. In the case of a corporation using the average earnings or income credit, if the present system were continued the increase in corporation-income-tax rates (and any possible future increases) would to that extent absorb an actual increase in profits over the base period and thus subject those increased profits to the lower corporation-income-tax rates rather than to the higher excess-profits-tax rates. Thus a taxpayer which earned $100 before payment of the corporation-income tax in the base period and which therefore had a credit of $84 (using a 16-per-cent average deduction for that tax) could earn approximately $122 free of excess profits, as the deduction of 31 per cent of $122 would produce an excess-profit net income equal to the credit. Hence, this taxpayer and one which continued to make only $100 would both be subject to the same tax rates, whereas the former taxpayer should be required to bear some additional burden. This will be accomplished under the new act. Under the change this act makes in the order of the deduction, the corporation-income tax is eliminated from both the computation of the base-period income, thereby increasing the credit, and from the computation of the current year's excess-profits net income, thereby increasing that income. But as a consequence of the increase in the corporation-income-tax rates, the latter increase is bound to be larger, so that more income is subject to the excess-profits tax.

In the case of the invested-capital method it may be argued that a credit based upon a return on invested capital assumes a return free of taxes and other charges, so that the present method is proper. However, the matter in the first instance simply depends upon the return on invested capital that is thought desirable. The reversal of the deductions is the equivalent of reducing the 8 per cent and 7 per cent to 5.5 per cent and 4.8 per cent respectively, in the sense that the latter percentages would produce the same results under the prior method of taking the deductions for the taxes as the former percentages yield under the new method. The policy question is whether the relief afforded by the invested-capital method should be at the old or new level. The choice of the new and lower level, i.e., the reduction in effect to 5.5 and 4.8

per cent, is an indication that the Congress believed the invested-capital credit provided a greater measure of relief than was proper from an excess-profits tax aimed at an increase in earnings in the defense period. Then, having so chosen the dividing line between those corporations able to pay an excess-profits tax on such increase in earnings and those not deemed able to pay such a tax, the Congress presumably desired the line to stay fixed despite changing corporation-income-tax rates. This permanence of this demarcation can in this respect be established only if the excess-profits tax is permitted to operate free of the corporation-income tax, just as in the case of the average-earnings credit where the line of demarcation was fixed on the basis of base-period earnings. Consequently, the shift in the precedence of the deductions is a justifiable measure.

In this connection, mention should be made of the more favorable treatment which the Congress accords in this act to new capital under the invested-capital method. This treatment was provided in recognition of the belief of many that a greater inducement is necessary to bring in new capital than to maintain existing capital. Such preferential treatment for new capital was thought to be especially advisable in view of the decreases made in the value of the invested-capital credit. Under this treatment there is added to the equity-invested capital for any day an amount equal to 25 per cent of the new capital for such day. In other words, so much of the equity-invested capital as represents new capital is included at 125 per cent, or, expressed in still different terms, new capital is allowed a credit of 10 per cent and 8.75 per cent instead of 8 per cent and 7 per cent. The computation of the amount of new capital is as follows: The items that may qualify as new capital are limited to money or property paid in for stock, or as paid in surplus, or as a contribution to capital, and taxable stock dividends made in taxable years beginning after December 31, 1940. New capital therefore does not include borrowed capital, new earnings retained in the business, or stock dividends declared out of earnings accumulated prior to the basic date. Moreover, money or property paid in by a corporation on a tax-free exchange, or what would be a tax-free exchange if the control test were 50 per cent instead of 80 per cent, and money or property paid in by a corporation where the corporation and taxpayer are members of the same controlled group, likewise on a 50-per-cent basis, are excluded. There is then charged against the amount of new capital tentatively ascertained under these limitations any increase in inadmissible assets which has occurred since the basic date. The resulting amount of new capital allowable cannot exceed, however, the absolute increase in total invested capital that has occurred in the intervening period between the basic date and the day for which the new capital is being computed. Thus decreases in borrowed capital will serve to decrease the amount of new capital allowable. An exception is made in the event of a decrease in over-all invested capital due to losses which have reduced the earnings-and-profits account.

Finally, with respect to the excess-profits tax, it should be noted that the carryovers from the year 1941 are to be computed on the basis of the changes made in this act, so that the amount of such carryovers will necessarily be reduced.

The only change made in the estate and gift taxes consists of an increase in the rates. This increase represents a combination of an absolute increase and the additional increase required to absorb the defense tax. The estate-tax increases are made effective immediately, whereas the gift-tax increases become effective for the calendar year 1942.

I do not think it advisable to spend time describing the excise-tax changes, most of which become effective this October 1st. In the excise-tax field, the defense tax was permanently integrated with the basic rates, the temporary taxes were made permanent, the rates of many existing taxes were increased, and a large number of new taxes on a variety of articles were added.

Before concluding this summary of the new act, it may be helpful to mention the more important of the items that were considered but later omitted, as such action is revealing in indicating the views of the Congress in the tax field. The most significant, and the most controversial item, was that of mandatory joint returns for husband and wife living together. Inserted by a decisive vote in the Ways and Means Committee and then rejected by a decisive vote in the House, this provision reappeared in a diluted form in the Senate Finance Committee in which it was aimed solely at the community-property states, only to be surrendered in even this form on the floor of the Senate without a vote. The injection of this matter in the bill precipitated a controversy in which everyone — tax expert, housewife, minister — felt qualified to pitch in and argue. Advocacy of, or opposition to, joint returns became almost fighting faiths. All this was to the good, for it focused popular attention upon one of the fundamental problems of the individual-income tax—in the case of married persons should there be discrepancies between the taxation of one economic unit as against another economic unit merely because of differences in the allocation of income within the unit? We have not heard the end of this matter, for rising tax rates should keep it to the fore. Moreover, the statement of managers on the bill specifically states that the entire problem—both mandatory joint returns and community-property income—will again be considered in the next revenue measure. Perhaps many people for the first time realized that the basic problems of taxation revolve about the allocation that is to be made of the fixed tax burden placed upon the country as a whole, for they saw that the millions in revenue lost through rejection of mandatory joint returns were obtained through the lowering of the personal exemptions. Of the 300 millions of dollars raised by lowering the exemptions, 280 millions will come from married persons. Thus the 300 million dollars in revenue which would have been raised under the mandatory joint returns provision from about 6 per cent of the married couples filing tax returns has been almost wholly shifted to the entire group of married persons. Consequently, a married couple whose ability to pay is no greater than that of the couple with the same total amount of income but with that income divided between the two spouses finds itself saddled with an increased tax liability through the lowering of the exemptions solely because the latter couple is not taxed in accordance with its full ability to pay.

The Senate, not to be outdone by the House in attempting to introduce tax innovations, adopted a new treatment of alimony which likewise went to the fundamentals of the concept of taxable income. Here the Senate agreed with the American ex-husband that rapidly rising tax rates had made chivalry too expensive, and therefore shifted the tax on alimony payments from husband to wife. You will recall that long ago in *Gould* v. *Gould* the Supreme Court ruled that alimony did not come within the statutory definition of income so that the wife was not taxable on such payments. In *Willcuts* v. *Douglas* the Court tightened its protective mantle around the wife by ruling that the income from alimony trusts was likewise taxable not to the wife but to the husband. Recently, however, the Court commenced to withdraw this protection and in a number of opinions held that some alimony trusts were taxable to the wife. The combination of hardship to the husband by reason of the heavy tax burden, especially in cases where his income had declined, and of hardship to the tax experts by reason of the confused state of the law, led the Senate to attempt a comprehensive solution of the problem.

In brief, it expanded the statutory definition of gross income to provide that periodic payments received by the wife under a decree of divorce or legal separation are includible in her gross income. At the same time the husband was given a specific deduction in the amount of all such payments so taxed to the wife. However, installment payments of a fixed total obligation, as distinct from periodic payments where only the yearly amount is fixed were not considered as income taxable to the wife but as transfers of capital assets. Similarly, the trust sections were amended to provide that there shall be includible in wife's gross income, the income which she receives from any trust which would otherwise be taxable to the husband, and that such income shall not be includible in his gross income. In view of this exclusion, no specific deduction was here necessary to accomplish the shift in tax burden. An exception was made in either instance for so much of the periodic payments or trust income as was specifically designated as payable for the support of minor children of the spouses. The requirement of specific designation, while perhaps a bit severe on the wife where a lump sum is paid for her and their support, served to avoid a difficult job of allocation. As a complementary provision, the ability to use the payments for the support of the children to bolster a claim to the credit for dependents was linked to the liability for tax on such payments.

The House, however, thought that the entire problem required further study and the Senate provisions were not adopted. But here, as in the case of mandatory joint returns, I believe that the technical manner in which the new approach was worked out is well worth your study, for any further consideration of these matters will, as respects technical details, start from the framework already built.

In the excess-profits-tax field the House was of the opinion that the increases in profits, largely due to defense contracts, which were through the alternative of the invested-capital credit being relieved of excess-profits taxation should be required to bear some tax burden in addition to that of the regular corporation-income tax. It therefore adopted, at the urging of the Treasury, a special 10-per-cent tax on so much of the profits in excess of the base-period credit as were untaxed under the excess-profits tax because of the taxpayer's use of the invested-capital credit. The Senate, however, refused to concede that the increased profits at this level should bear a 10-per-cent tax in addition to the 31-per-cent corporation-income-tax rate, and the provision was stricken from the bill. It will be observed that here the Treasury was seeking to insure that all so-called defense profits paid some additional tax besides the regular corporation-income tax. Of course this is only part of the problem of excess-profits taxation. The other aspect is whether it is enough to reach so-called defense profits alone or whether, in obtaining the added funds that must come from corporations because of the need for increased revenues, a more selective method should be used than the regular corporation-income tax applicable alike to all corporations. Whether this selection should be through expansion of the excess-profits tax in the other direction, that is, subjecting to excess-profits-tax earnings in excess of a stated percentage on invested capital though not in excess of base-period earnings, or through an undistributed-profits tax of one kind or another, or through some other method is a problem which this Congress did not attack in this act, but which must be considered in the near future.

Finally, as respects the capital-stock tax and the declared value excess-profits tax, the Senate struck a severe blow at the clairvoyants by permitting an annual declaration of capital-stock-tax values. This abandonment of the three-year declaration would, of course, in addition greatly simplify the capital-stock tax by eliminating the need for adjustments in the value declared for the first year. But the House refused to cast into oblivion the great American guessing contest which these taxes afford, despite the additional obstacles now presented by priorities, defense contracts, and like matters. Consequently, you gentlemen had best polish your crystals and turn to your finest tea leaves. If it be any comfort to you, the Treasury supported the annual declaration of value as the next best step if the taxes are not to be scrapped entirely—a result which in my opinion should be accomplished.

To recapitulate, the new act is almost entirely confined to the raising of additional amounts of revenue through increases in the rates of existing taxes and through the imposition of new excise taxes. So-called "administrative" or "technical" matters are scarcely touched by the act. This was the result of a deliberate decision on the part of the Congress, joined in by the Treasury Department, to avoid the delay which the injection of such matters would have involved. This decision was buttressed by the announcement that a second revenue measure would soon be forthcoming which would deal solely with these matters. Now, it is almost impossible to define the terms "administrative provision" or "technical provision" as used by a Congressman. Many taxpayers believe that these terms are indiscriminately applied to any provisions which a Congressman does not favor at the time. Generally speaking, however, these are the provisions which enable you and me to earn our living, for they are the bricks and mortar of the structure which we endeavor to make appear as mysterious as possible to the uninitiated. It may therefore be of interest to mention, even though briefly, some of the provisions which were postponed for consideration in the "administrative bill" to follow.

To start at random, in addition to mandatory joint returns, community property and alimony, which were mentioned above and which the Congress has stated would be considered in the administrative bill, there is the matter of so-called investment expenses. Here taxpayers seek a legislative reversal of the Supreme Court's decision in *Higgins* v. *Smith* denying the deductibility of such expenses, and the Treasury Department agrees that such reversal is desirable. Next, revision is needed in the personal-holding-company tax, so that companies which distribute all of their incomes should not be nevertheless subject to tax as at present because of a discrepancy between income in the measure of the tax base and earnings and profits in the measure of the credit. Then there is the difficult problem of mortgage foreclosures and bankruptcy reorganizations. In this field there are a number of cases awaiting decision by the Supreme Court, but despite whatever clarification these decisions may produce, the Congress will undoubtedly be called upon to take legislative action. Next, the difficult question of the method of taxing insurance companies was mentioned repeatedly in connection with this act, most of the Committee members indicating that revision in the direction of increased tax liabilities is necessary. The Congress likewise agreed that the Treasury Department's recommendation for amortization of bond premium and discount merited further study. Under this recommendation taxpayers on the accrual method would be required to accrue the premium and discount on bonds they had purchased, in the case of a premium the accrual being offset against and thereby reducing the interest accrued. Taxpayers on the cash-receipts method would be required to take similar action in the case of tax exempt or partially tax-exempt securities. The consequence of thus resorting to the effective rate of interest rather than the coupon rate would in the case of taxable securities purchased at a premium replace the present annual tax on the coupon rate and a capital loss on disposition of the bond with simply an annual tax on the lower effective rate of interest. If the bond were purchased at a discount, the annual tax on the coupon rate and the capital gain on disposition of the bond would be replaced by an annual tax on the higher effective rate of interest. Incidentally, such amortization of discount was confined to bonds purchased at a discount of 10 points or more, as the payment of the discount on redemption in the case of bonds with a greater discount is too speculative to warrant such treatment. In the case of a tax-exempt security purchased at a premium, it would mean the elimination of the present gratuity of a capital loss upon disposition of the bond, and correspondingly, the elimination of a capital gain if the bond were purchased at a discount.

In connection with the excess-profits tax, the Treasury has for some time been giving consideration to the suggestions for revision that have been received from taxpayers and other sources. Mention need be made of but a few of these technical matters to indicate the types of problems under consideration—the allowance of the growth credit to Supplement A corporations, revision of the method of computing the credit under Supplement A to allow full weight to be given to base-period experience, re-examination of the effect of tax-free liquidations on invested capital, computation of equity-invested capital where the basis of property or stock cannot be ascertained, combination for administrative purposes (such as statutes of limitation, deficiencies, etc.) of the three taxes turning on income, the income tax, excess-profits tax, and declared value excess-profits tax, re-examination of Supplement B, and so on.

In the estate- and gift-tax field, study is being given to the difficult problem of more adequately integrating these taxes with each other, and with the income tax. Also, expansion of the scope of the gross estate subject to tax, such as in the field of powers of appointment, is being studied.

It is in connection with this administrative bill that you gentlemen will have a vital rôle to play. To begin with, a workable method of obtaining necessary technical changes in the revenue laws has not been achieved. In recent years the preoccupation with changes in tax rates and with the adoption of new taxes has served to crowd such technical changes into the background. This latest tax bill was confined almost entirely to matters of tax rates and new taxes, yet six months have been consumed in its enactment. With the need for increased revenue as pressing as ever, we must devise some system whereby these needed technical improvements can be accomplished without undue interference with the revenue-raising legislation. Unless we do this, inequalities and inequities in our revenue system will rapidly increase to a dangerous degree.

In the next place, intelligent, painstaking, and impartial thought must be devoted to the task of ascertaining the administrative or technical improvements that are necessary. This burden falls alike on the Treasury and on tax experts in the legal and accounting professions. You gentlemen, both in person and through your committee on federal taxation, can be of immense aid to the Congress in the difficult task that lies before it. Unless we are careful, there is the danger that an administrative bill will develop into a scramble for selfish gains. It is in the interest of all concerned—Treasury Department, tax practitioner, and taxpayer—that we unite in our efforts to obtain as fair and as equitable a tax structure as is possible.

Depreciation at Accelerated Rates

BY WALTER A. HURLEY, NEW YORK

Member, American Institute of Accountants

WITH the current sharp increase in industrial activity and income taxes, the subject of accelerated depreciation seems timely. Despite its engineering features, it is largely an accounting problem, and becomes increasingly more important. This paper represents an earnest effort to collect and concisely present authoritative data on the subject for federal income-tax purposes, without attempting to inject any new thoughts or arguments, or to consider the subject of accelerated depreciation in connection with the examination of financial statements.

Not to put too fine a point on it, accelerated depreciation may be defined as an increased depreciation charge to cover additional wear and tear on fixed assets subjected to extraordinary usage during a period of abnormal activity.

FACTORS CAUSING INCREASED DEPRECIATION

When depreciation is computed on the unit-of-production basis, the provision automatically increases during periods of abnormal activity, and the question of accelerated depreciation is less important. Nevertheless, certain of the factors to be presented are as applicable when that basis is employed as under the more common straight-line method, which is assumed in the following discussion. What then are some of the factors causing increased depreciation? Those which have been generally recognized may be enumerated as follows:

1. An increase in the length of the working day. This is the most common factor,—either as overtime or by additional shifts—and results in a consequent increase in the wear and tear per unit of time over the exhaustion contemplated in the normal rate.
2. Operation of machines for more than one shift. There is a detrimental effect on machines used two or three shifts, necessarily by different persons, for no two men operate a machine in exactly the same manner. It has also been observed, when responsibility is so divided, that operators do not take as good care of the machines, and each tends to leave to the succeeding shift the burden of minor adjustments and repairs. This is particularly true of piece-workers. Then too, the inefficiency of men on night work, and its ill effect upon the machines, has been generally recognized.
3. A speed-up of machinery. Accompanying the extension of the working day may be an increase in the speed at which certain machinery is operated, resulting in a higher than normal rate of exhaustion. Somewhat akin to this may be the added strain put upon the heating and power facilities and other auxiliary departments. While the increased wear and tear may be partially offset by additional maintenance, it often results in increased deterioration.
4. Reluctance to halt production for re-

pairs. When factory superintendents are pressed to increase productivity, they are reluctant to halt machines for repairs which can possibly be deferred, especially where the manufacturing process is in a more or less continuous flow, and the stoppage of one machine may effectively shut down others. But the operation of such a machine until the end of the day or week, when the maintenance department can make the necessary repairs without interrupting production, may considerably shorten its useful life.

5. Shortage of skilled labor. Plants which normally operate one shift, and increase their schedule to double and triple shifts, may have to entrust the operation and maintenance of certain machines to persons of little experience or training. For machines which must produce within narrow tolerances, this might accelerate the depreciation considerably. When there is added to this the difficulty of obtaining proper replacement parts, which has sometimes been the case, the hardship on the machine is marked.
6. Machines perform operations for which not primarily designed. In times of pressure machines may be used to do work which is different from that for which they were intended, or available raw material may be more difficult to process than the quality for which the machine was originally constructed. Either condition may work a hardship on the machine, and contribute to its physical depreciation.

In establishing a normal rate of depreciation, in addition to the factor of wear and tear, allowance is usually made for obsolescence and for deterioration due to natural causes. As the latter two of the three elements of depreciation are more or less constant, the rate of depreciation will not ordinarily accelerate in the same ratio as the increase in the wear and tear of the asset under consideration.

Accelerated Depreciation Studies

Perhaps the most widely cited text on the subject is Nicholson and Rohrbach's *Cost Accounting*,[1] which was written about the time of the first World War, when the subject first became important. Therein the authors quote in full the views of an auditor of a steel corporation, which were presented in a memorandum prepared for the War Industries Board. In a table set out in the memorandum it was estimated that, on the basis of a normal working day of eight hours, depreciation increased hourly to 150 per cent of normal for 16 hours and to 250 per cent for 24 hours of operation. The authors, however, assume that no manufacturer would consider for a moment running his machinery continuously without repairing or adjusting it. If he did, the machines would soon break down and stop production. On this premise they suggest that at no time should the normal rate be increased more than 100 per cent. In an hourly table based upon a normal ten-hour operation they recommend an increase of 30 per cent for 16 hours, and 95 per cent for 24 hours.

The *Accountants' Handbook* [2] cites the report of the committee on depreciation of the Atlantic Shipbuilding Association, which recommended that rates be increased 6¼ per cent of normal for each hour of operation over eight. Thus the normal provision would be increased by one-half for a two-shift operation and and doubled for three shifts.

In his *Depreciation Principles and Applications*,[3] Saliers presents a table of rates for seven general classes of depreciable assets when used in one-, two- and three-shift operations. After considering the effects of overtime and multiple-shift operations, with its incident factors of inadequate repairs, divided responsibility, night work, unskilled labor, and mechanical fatigue,

[1] Pp. 156–160.
[2] Second Edition, p. 658.
[3] Third Edition, pp. 148–151.

he generally concludes that two shifts warrant an increase of 25 per cent over normal rates, with a 50-per-cent increase for three shifts.

In December, 1940, the National Association of Cost Accountants made a survey of current depreciation policies and practices. The report [4] covered 245 industrial companies and revealed that 56 had experienced an increase in business sufficient to justify consideration of accelerated depreciation. Of this number, 32 had already increased rates for certain types of assets or were considering doing so. The report pointed out that there is likely to be a lag between a change in business conditions and the adoption by management of changes in accounting methods; also, that interest in the subject had increased since the information was obtained. Thirty-two companies suggested the per cent of increase over normal rates which they would consider proper for a 100-per-cent increase in production. Suggested increases ranged from 20 to 100 per cent, but the norm appeared to be 50 per cent.

Law and Regulations

There is, of course, nothing in the law or regulations which prevents a taxpayer from revising upward his allowance for depreciation if warranted by the facts. The Code provides that there shall be allowed as a deduction "a reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence." [5] The Commissioner in his Regulations states that the allowable amount need not necessarily be at a uniform rate,[6] and whatever plan or method is adopted must have due regard to operating conditions during the taxable period.[7]

More particularly, the Internal Revenue Bureau issued in January, 1931, Bulletin "F," dealing with the subject of depreciation. In the section treating of the effect of abnormal or unusual conditions it was recognized that "property, for example, manufacturing machinery, may be subject to extraordinary depreciation due to being used for some purpose for which it is not adapted or operated at an overload, or overtime, etc. Under such conditions a taxpayer may deduct in addition to the amount measuring the depreciation under normal conditions a further sum to provide for the extraordinary depreciation." The bulletin then explains that the increased depreciation is not necessarily proportionate to the increase in the hours of operation, but points out, "on the other hand, continuous operation over long periods might work an increasing ratio of wear and tear over and above the increase in hours of service."

The Committee on Appeals and Review had earlier recommended that "when delicate machinery designed for the manufacture of a certain product is used in manufacturing a product of much coarser materials for which it is not fitted, and is operated at a heavy overload of its normal capacity, the owner is entitled to deduct from gross income an amount representing extraordinary depreciation." [8] In another case, where a plant was operated at double time, the Committee recommended a depreciation allowance of 140 per cent of the normal rate.[9]

B.T.A. and Court Cases Reviewed

The allowance for depreciation being a question of fact, it is not surprising that few cases involving accelerated depreciation are to be found outside the Board of Tax Appeals. But here in some thirty-odd cases the taxpayers run the whole gamut, and a reading of the Board's opinions covers all the causes of

[4] N.A.C.A. Bulletin, Vol. XXII, No. 16, Section III.
[5] I.R.C. § 23(1).
[6] Regulations 103, § 19.23(1)–1.
[7] Regulations 103, § 19.23(1)–5.

[8] A.R.R. 45, 2 C.B. 141.
[9] A.R.R. 390, 4 C.B. 371.

accelerated depreciation enumerated earlier.

While the petitioners' counsel have not generally rested their contentions for accelerated rates on some single ground, there are several cases which seem solely to turn upon the increase in the number of hours machinery was operated. The Board allowed *MacDonald-Kaitchuch Printing Co.,*[10] which normally operated eight hours a day, a 100-per-cent increase when it operated 22 to 24 hours; and allowed *Stockbridge, et al.*[11] three times the amount granted by the Commissioner because of continuous day and night operation of its cotton-seed oil plant. A 50-per-cent increase was allowed *Neisler*[12] for the months its cotton mill operated double time; similarly, *Atlas Tack Co.*[13] sustained additional depreciation of its machinery and equipment and its power plant because of overtime use; and *Drayton Mills,*[14] operating approximately 30-per-cent overtime, was proportionately increased from 5 to 6½ per cent. The Board agreed that double shifts resulted in a very heavy strain on the paving machinery of *Heaton Construction Co.;*[15] and *Stephens Fuel Co.*[16] proved that motors used overtime in hauling coal suffered depreciation of 30 per cent, as compared to 25 per cent conceded by the Commissioner. An interesting feature of the appeal of *Fort Orange Paper Co.*[17] is the showing that the taxpayer twice increased its rates in a four-year period, although conditions appeared to be the same in all years, and the company was permitted to use the highest rates in computing its tax liability for the two years before the Board. The Commissioner's rate of 5 per cent on machinery and equipment was increased to 7½ per cent for *Camden Woolen Co.*[18] Not only was its mill operated two shifts about half the time, but because of the poor financial condition of the company it could not maintain its property in good repair.

The Board permitted *Crown Mfg. Co.*[19] to increase its composite rate for overtime operation of a cotton mill, finding that the night operators did not take as good care of the machines as the day operators. Although the Board denied the taxpayer's claim in *Avon Mills*[20] for a rate higher than double the normal allowed by the Commissioner, it found that when operations increased from 60 to 120 hours per week there was a lower degree of efficiency among the workers, particularly the night men. It was also found that because the operation was continuous, the machinery was not kept oiled and in the state of repair usual in normal times.

The work week of *Nokomis Cotton Mills*[21] was only increased from 55 to 70 hours, yet the Board approved a 40-per-cent increase in rate when looms were speeded up about ten per cent. But the mere speeding up of machinery, of itself, does not warrant an increased allowance. In *Dill & Collins Co.*[22] the Board found that the machinery in two paper mills owned and operated by the taxpayer were speeded up during 1920, but insufficient facts were introduced to determine the extent, if any, of the increased depreciation. Nor did the Board feel a higher rate was justified by the mere increase in the dollar volume of the department store sales of *Mandel Bros.*[23] although the opinion indicates what facts might have been introduced.

A number of factors were proved in the appeal of *Filer Fibre Co.*[24] Its pulp mill normally operated 24 hours a day and had a daily production of 20 tons,

---

[10] 4 B.T.A. 996, acq. X-2 C.B. 44.
[11] 2 B.T.A. 327, acq. X-2 C.B. 68.
[12] 18 B.T.A. 184, acq. X-2 C.B. 51.
[13] 9 B.T.A. 1322, acq. X-2 C.B. 4.
[14] 19 B.T.A. 76, acq. X-2 C.B. 20.
[15] 11 B.T.A. 1302, acq. X-2 C.B. 30.
[16] 13 B.T.A. 666, acq. X-2 C.B. 67.
[17] 1 B.T.A. 1230, acq. X-2 C.B. 24.
[18] 12 B.T.A. 1277, acq. X-2 C.B. 11.
[19] 12 B.T.A. 37, acq. X-2 C.B. 17.
[20] 7 B.T.A. 143, acq. X-2 C.B. 4.
[21] 2 B.T.A. 1205, acq. X-2 C.B. 52.
[22] 18 B.T.A. 638.
[23] 4 B.T.A. 341.
[24] 14 B.T.A. 757, acq. X-2 C.B. 23.

which it increased to 30 tons during the year 1920. Due to the pressure of production it did not shut down over the week-end, and repairs were made while the machines were in operation. These repairs left much to be desired, and permitted greater than normal wear and tear. Then too, because of governmental priorities, inferior grades of materials and machinery had to be used. An interesting feature of the computation was the use of composite rates applied to the diminishing balances in the building and equipment accounts. The *Champion Coated Paper Co.*[25] also normally operated 24 hours a day for six days a week. Here, too, the Board found that the demand for the product was great enough to warrant continuous operation without sufficient stoppage for thorough repairs. This and the fact that inexperienced help was employed to fill vacancies created by men who were drafted, or left because of higher wages paid by other plants, caused greater wear and tear than was normal in prior years.

The Court of Claims allowed accelerated rates in *Hyatt Roller Bearing Co., et al.* v. *U. S.*,[26] finding that the plants were in almost constant operation, and the company was compelled to employ, to a large degree, persons who were unskilled and incompetent to operate properly and care for the machinery and equipment. Skilled operators and repair men were replaced by unskilled help in *Harmony Grove Mills*,[27] which only worked five hours per week overtime but was allowed a 40-per-cent increase in depreciation. It was there brought out that the superintendent was ill and unable to see that proper repairs were made. *Blair Veneer Co.*[28] also employed unskilled operators and was granted an increase in its composite rate. A 50-per-cent increase was approved for *Neuse Mfg. Co.*,[29] which operated an average of 70 per cent overtime for a three-year period, the Board also finding that the help was untrained and the output inferior. During 1918 and 1919 *Planters Nut & Chocolate Co.*[30] was allowed to increase from 10 to 15 per cent its depreciation charge, the machinery being operated overtime by inefficient help. A shortage of repair parts accelerated the depreciation of machinery of *Wilkes-Barre Lace Mfg. Co.*[31] during the years 1918 and 1919. After exhausting its reserve supply of replacement parts, it dismantled some machines and used the parts to repair others. Finally it was forced to allow all the machines to fall into a state of disrepair, greatly impairing their operation. While allowing rates of 12½ per cent for 1918 and 10 per cent for 1919, as compared to the normal rate of 5 per cent, the Board went out of its way to state that the cost of the repairs made in subsequent years, when the machines were overhauled, could not be allowed as an expense nor could they be capitalized, but must be charged against the depreciation reserve to the extent of such increased allowance. Having full knowledge of the nature and extent of the repairs subsequently made, as the Board did in that case, the proviso may have been fair in the circumstances, but as a principle it seems of doubtful value. The thought that additional repairs completely offset rather than indicate accelerated depreciation seems to have been in the mind of the district court in *B. L. Marble Chair Co.* v. *U. S.*[32] when the taxpayer, admittedly employing its machinery overtime, was denied additional depreciation because its repairs were much greater than in previous years.

An example of increased depreciation caused by using machines to do jobs for which they were never intended was recently presented in the Board's memorandum opinion in the appeal of *Mary*

[25] 10 B.T.A. 433, acq. X-2 C.B. 13.
[26] 70 Ct. Cls. 443; 43 F. (2d) 1008; 2 U.S.T.C. ¶588.
[27] 2 B.T.A. 1200, acq. X-2 C.B. 29.
[28] 5 B.T.A. 886, acq. X-2 C.B. 7.
[29] 1 B.T.A. 769.
[30] 7 B.T.A. 173, acq. X-2 C.B. 57.
[31] 1 B.T.A. 467, acq. X-2 C.B. 76.
[32] Dist. Ct., N. D. Ohio, Eastern Div., At Law No. 16652, February, 1932; 5 U.S.T.C. ¶ 1500.

L. Lewis, et al.[33] In that case the taxpayer undertook a contract to clear away rock and dirt for the development of a park. Although not designed for such work, tractors and other heavy machinery having a normal useful life of five years were used. Moreover, in order to complete the work within the limited time of seven months, the equipment was operated 24 hours a day, seven days a week. Dirt and rock dust affected the machinery, which could not be kept in a proper state of repair. The Board upheld the taxpayer's contention that the equipment should be depreciated 60 per cent after seven months' use. The use of machinery for processing a different grade of raw material than that for which the machines were designed was the principal reason for the Board's allowance of additional depreciation for the *Boyer Co.*[34] In undertaking the manufacture of worsted yarns suitable for army uniforms, a heavier and coarser grade than usual was required, the manufacture of which placed a heavy strain on the spinning machines, causing irreparable damage. The new product also caused the machines to vibrate to such an extent as to augment the normal depreciation of the building. Substitute materials also contributed to accelerate depreciation of the candy manufacturing machinery of *Levine Bros. Co.*,[35] which was allowed a 50-per-cent increase in rate. In addition to the factors of overtime and unskilled labor, war conditions required the use of brown sugar in place of powdered sugar, and substitutes for other ingredients had to be used.

Several petitioners presented rather novel contentions, which appear to have impressed the Board. In some cases they were, however, additional rather than the sole grounds for their claims. *Hickory Spinning Co.*[36] showed that machinery was housed in buildings situated near a railroad where as many as thirty heavy trains a day passed. The vibration caused by the trains so affected the machinery that it could not be properly adjusted. A similar factor was contended by *Avon Mills*,[37] mentioned earlier, with the additional feature that in the summer the doors and windows facing the railroad were kept open, permitting cinders to blow in and injure the machinery. In *Pitzman's Co. of Surveyors & Engineers*[38] depreciation was allowed on survey records which had been in existence for many years, although depreciation had not previously been claimed. Due to increased business, the Board found the records had been neglected and greatly depreciated. A peculiarly war-time factor was advanced by *Alabama Coca-Cola Bottling Co.*[39] Prior to 1917 it computed its depreciation of plant and equipment on the basis of five cents a case of all its bottled products sold during the year. For the years 1917–1920 it increased its depreciation to ten cents a case. It apparently enjoyed a large business with an army camp near by, but not without some unusual costs. The heavy trucks used by the Army so cut up the roads as to incur more than usual wear and tear on the company's delivery equipment, causing excessive breakage of bottles as well. Then, due to conditions in the camp, which were not fully explained in the opinion, there was a heavy loss from failure to return bottles and cases. The Board allowed ten cents a case for the year 1918 but, because the population of the camp decreased rapidly after the Armistice, it disallowed the increased rate for the years 1919 and 1920.

Although a number of petitions to the Board for accelerated depreciation are reported as disallowed, it will be found that in some instances additional

[33] Dockets 100280 and 100281, April 17, 1941.
[34] 4 B.T.A. 180, acq. X-2 C.B. 8.
[35] 5 B.T.A. 689, acq. on this issue X-2 C.B. 41.
[36] 2 B.T.A. 439, acq. X-2 C.B. 31.
[37] 7 B.T.A. 143, acq. X-2 C.B. 4.
[38] 21 B.T.A. 1368, nonacq. X-2 C.B. 98; appeal dismissed 53 F. (2d) 1080.
[39] 1 B.T.A. 837, acq. X-2 C.B. 1.

depreciation had already been agreed to by the Commissioner, and only the further amount claimed by the petitioners was denied.[40] In some cases, of course, the taxpayers failed to carry the burden of proving that the Commissioner committed error.[41]

When confronted in actual practice with the difficulty of deciding what weight to give the various factors which may be present, some consolation may be had from the Court's recognition that "Although the deduction allowable on account of depreciation is to be based upon the actual wear and tear sustained during that year, it is obvious that actual wear and tear of machinery and equipment is not ordinarily susceptible of scientific measurement in any one year,"[42] and the Board's view that "it must be recognized that there is no method by which depreciation may be computed to the ultimate penny. All we can hope is to arrive at a fairly accurate allowance in the light of all the circumstances."[43] The allowable amount, therefore, seems largely to resolve itself into a matter of judgment, which is part of the stock-in-trade of all public accountants.

[40] Avon Mills, 7 B.T.A. 143; Woodside Cotton Mills Co., 13 B.T.A. 266; Brampton Woolen Co., 18 B.T.A. 1075.

[41] Diamond Alkali Co. v. Heiner, 60 F. (2d) 505, 5 U.S.T.C. ¶1520; Eagle Dye Works, 1 B.T.A. 638; Walker Creamery Products Co., 2 B.T.A. 474; Mandel Bros., 4 B.T.A. 341; Chicago Railway Equipment Co., 4 B.T.A. 452; Dill & Collins Co., 18 B.T.A. 638; Merrill Silk Co., 26 B.T.A. 80.

[42] Diamond Alkali Co. v. Heiner, *supra*, n. 41.

[43] Crown Mfg. Co., 12 B.T.A. 37.

Relief Sections of the Excess Profits Tax Law

BY SCOTT H. DUNHAM, SAN FRANCISCO, CALIF.

Member, American Institute of Accountants

EXCESS profits resulting from the national-defense effort or the impending greater emergency should in equity be subject to high taxes or commandeered to help meet the cost of the defense program. These high or confiscatory taxes should apply only to profits above those necessary to ensure required industrial expansion and unimpeded acceleration of productive activity. This practical limitation on tax policy is necessary for the preservation of our economic institutions and the American way of life that has established the greatest nation on earth.

Careful consideration was given to the definition or determination of excess profits preliminary to the enactment of the introductory excess-profits-tax act that is now in force. As a result, the general definition of "excess profits tax income" the base for computing excess profits was framed with considerable care [1] and dual credits were allowed one, based on the taxpayer's invested capital,[2] and the other on average earnings for the base period [3] in order to impose a tax only on "excess profits."

In recognition of the fact that a general definition of "excess profits" cannot be made without taking circumstances pertaining to the business producing the profits into consideration there were many relief provisions in the original law.[4] Some of these represent a specific response to cases which were brought to the attention of Congress at

[1] Section 711 (a) (1) and 711 (a) (2) of the Internal Revenue Code.

[2] Sections 714 to 720 of the Internal Revenue Code.

[3] Sections 711 (b), 712 and 713 of the Internal Revenue Code.

[4] See Appendix A for outline of these relief provisions.

the time the law was under consideration.[5]

In view of the haste in which the original law was enacted, equitable relief provisions were not set forth in the original law. Congress impliedly promised, however, that after careful study, such provisions would be enacted. Consonant with this promise [6] the act was retroactively amended in March, 1941, in order to incorporate equitable and relief provisions in the law.

All provisions of the law which reduce "excess profits" [7] subject to present graduated taxes and higher taxes that are in prospect are worthy of consideration. The relief sections relating to special treatment of abnormal deductions in the base period,[8] unusual or excessive income received subsequent thereto [9] and the construction of a normal base-period income experience in cases where the character or nature of the business changed prior to January 1, 1940, or where business was interrupted during the base period due to abnormal events[10] are the most important and far-reaching relief sections. Proper application of these relief provisions will require careful and judicious application of both the taxpayer and the administration. In view of the limited time available, this discussion is of necessity limited to the consideration of relief granted in the three important cases relating to treatment of abnormal or excessive income or deductions, and to "the might-have-been sections," permitting the reconstruction of the income credit.

The adjustment of abnormal or excessive deductions or income should be duly reflected in excess-profits tax returns. Thus, relief granted in two cases reduces the tax liabilities set forth in returns. This relief is immediate. The relief granted in cases where it is necessary to reconstruct base-period net income cannot reduce the tax set forth on excess-profits-tax returns until such time as the Commissioner acquiesces in the propriety and correctness of such adjustments.[11]

Revision of Base Period Income Due to Abnormal Deductions

Provisions relating to the adjustment of income for each base-period year in order to eliminate abnormal deductions represent a laudable attempt to determine a fair norm for use in computing "excess profits."

In order to determine normal income for each base-period year the law generally provides that deductions of any class shall be disallowed if abnormal, and if normal, that the amount to be disallowed represents the excess of the class of deductions over 125 per cent of the average amount of such class of deductions for the test period consisting of the previous four years. In case the taxpayer was not in existence for four years, the test period comprises the number of previous years the taxpayer was in existence and the number of succeeding years (which begin before the commencement of the second excess-profits-tax taxable year) beginning with the first of such years but in no case to aggregate more than four years.[12]

As a condition to the disallowances of each abnormal deduction in the base period, the taxpayer must establish that the abnormality or excessive deduction was not the consequence of (a) an increase in gross income in the base period; (b) a decrease in the amount of some other deduction in the base period; or (c) the change at any time in

[5] See Senate hearings on H. R. 10413, pp. 221–23 relating to income from long-term contracts and interest on a tax claim. *Ibid.*, 479–80, 491–92.

[6] House Report No. 146, I.R.B. 1941–11, pp. 39–40.

[7] See Appendix B for an outline of relief provisions now in effect.

[8] Section 711 (b) H to K of the Internal Revenue Code.

[9] Section 721 of the Internal Revenue Code.

[10] Section 722 of the Internal Revenue Code.

[11] Section 30.722–5 (c) of Regulations 109.

[12] Section 711 (b) (K) (i) of the Internal Revenue Code.

the type, manner of operation, size, or condition of the business.[13]

There is one further limitation on the disallowance of the "abnormal deductions." Under this limitation, the deductions of any class disallowed for any year is limited to the excess of deductions of that class for the base-period year over deductions of the same class for the current year for which the tax is being computed.[14] This limitation fails to take cognizance of acceleration in operations and business changes that may make comparison of deductions meaningless. Thus, purely abnormal deductions have to be compared with deductions of the same class in a period of extraordinary activity. There is some merit in this limitation, however, since all abnormal losses such as losses arising from theft, casualty, or extraordinary business losses constitute allowable deductions in the current period, and they are excluded in their entirety or to the extent they constitute "abnormal" deductions in determining the base-period-income credit.[15]

Taxpayers ordinarily resist the disallowance of deductions. This is an instance where the disallowance will normally be hailed as a blessing since the disallowance of deductions for the base period increase the income credit except in cases where such adjustments reduce the excess of earnings for the last half of the base period over earnings for the first half of the period.[16]

Vigilance must be exercised each taxable year in determining the "income credit" in light of the guarded restrictions on the disallowance or elimination of abnormal deductions in the base period. In applying this relief section it is first necessary to group deductions for each base-period year, for each test-period year, and for the current year by classes. The law gives two examples of the classification of deductions [17] and provides that deductions other than those specifically mentioned shall be classified in accordance with the Commissioner's duly approved regulations.[18] The first class consists of deductions attributable to any claim, award, judgment, or decree against the taxpayer or interest thereon; the second comprises intangible drilling and development costs for drilling or preparation of oil or gas wells, and costs of developing mines. The regulations set forth a very flexible rule for the classification of deductions.[19] The classification must be reasonable in light of the business experience and accounting practice of the taxpayer and they must be consistent with classifications used in classifying abnormal income.[20] Any reasonable classification of expenses based on general accounting records complies with the spirit of the law and the regulations pertaining to classifying deductions. Here is a case where accounting practices may have a significant effect on the determination of taxable income. In cases where satisfactory accounting records have not been maintained, it may be necessary to follow the classifications of deductions provided on corporation income-tax returns in classifying deductions and arriving at the base to be used in the application of the test for the determination of abnormalities.

The various classes of deductions for each base-period year should be care-

[13] Section 711 (b) (K) (ii) of the Internal Revenue Code.

[14] Section 711 (b) (K) (iii) of the Internal Revenue Code.

[15] Section 711 (a) allows all abnormal deductions in current year, which are excluded in whole or in part under subparagraphs (D) (E) (H) (I) and (J) of section 711 (b).

[16] An increase in income for the first half of the period obviously reduces the amount added to income of the second half in cases where the income credit is determined under section 713 (f).

[17] Section 711 (b) (H) and (I) of the Internal Revenue Code.

[18] Section 711 (b) (J) of the Internal Revenue Code.

[19] Regulations 109, section 30.711 (b)–2 (a).

[20] Section 721 of the Internal Revenue Code and interpretative regulations set forth principles to be followed in classifying abnormal income.

fully reviewed in light of code provisions relating to the elimination of abnormal deductions in the base period. Each class of deductions might properly provide an excludable abnormal deduction and consequently produce a tax saving.

Preparatory to the preparation of excess-profits-tax returns, deductions for each base-period year should be classified and compared with deductions of the same class for the year for which the return is being prepared in order to determine the excess of deductions for the base period over those of the current year. In case deductions of any class for any base-period year exceed deductions of the same class for the current year, such deductions for the base period should be reduced by 125 per cent of deductions of the same class for the test period, consisting of the four previous years, or in case the taxpayer was not in existence for such period, the previous years of the taxpayer's existence and sufficient immediately succeeding years to make a total of four years. The test period may consist of less than four years since the period cannot include years commencing after the close of the first year for which the taxpayer was subject to the excess-profits tax.[21] The excess of each class of deductions over 125 per cent of deductions of the same class for the test period constitutes "abnormal deductions," and such "abnormal deductions" may be eliminated in computing income for the base-period year. The amount of the elimination, however, is limited to the lower of the aggregate excess of each class of base-period deductions over 125 per cent of deductions of the same class for the test period or the excess of deductions of the base-period year over deductions of the same class for the current year.[22] Such "abnormal deductions" may not be eliminated in computing base-period income unless the taxpayer proves that the abnormality does not result from increase in the taxpayer's gross income in any base-period year; decrease in the amount of some other deduction in any base-period year; or a change at any time in the character, size, or condition of the taxpayer's business.[23] The burden is on the taxpayer to prove that the abnormality or excess does not fall in one of the foregoing categories.[24] By being attentive to detail, the average taxpayer will be able to demonstrate that some abnormal deductions should be eliminated in computing income for one or more of the base-period years. In many instances, expenses were incurred and deducted during the base period pertaining to activities in years prior to the commencement of the base period. This fact and other pertinent facts should be demonstrated in sustaining abnormal deductions for the base period.

Abnormal Income Received During the Current Year

The excess-profits tax should apply only to current excess earnings or profits. It is difficult to meet this objective inasmuch as the excess-profits-tax law is superimposed on the income-tax law which includes income wholly extraneous to the current year in taxable income for income-tax purposes.[25] The application of graduated excess-profits-tax rates now in force or in prospect[26] to "abnormal income" attributable to activities in other years

[21] Section 711 (b) (K) (i) of the Internal Revenue Code.

[22] Section 711 (b) (K) (iii) of the Internal Revenue Code.

[23] Section 711 (b) (K) (ii) of the Internal Revenue Code.

[24] Regulations 109, section 30.711 (b)–2 (b) sets forth data required in support of "abnormal deductions" eliminated in the base period.

[25] Section 711 (a) and (b) of the Internal Revenue Code use income as defined in the income-tax provisions of the Code as a starting point and the law is based on past and current income laws.

[26] See Appendix C for summary of changes in the existing law proposed in H. R. 5417 as approved respectively by the House and Senate.

would inevitably result in severe hardships. In order to alleviate hardships, such income is, for excess-profits-tax purposes only, allocated to the years to which it is reasonably attributable.[27] Thus, abnormal income attributable to other years is allocated to such years in determining excess profits reflected on tax returns. In order to substantiate action in eliminating the abnormal income, the taxpayer must show that it normally does not receive such class of income, or if it does, that it normally receives smaller amounts of such income. Abnormal income in the latter case includes each class of income received during the current period which exceeds 125 per cent of the average amount of gross income of the same class for the previous taxable years or the period of the taxpayer's existence if the latter is less than four years.[28] Thus, abnormal income is given a very general definition and as in case of abnormal deductions it may be abnormal either in kind or amount.

The receipt of income abnormal in kind or amount will not serve as the basis for relief unless reasonably compelling proof can be compiled to demonstrate that all or part of each item of income comprising each class of abnormal net income is attributable to activities or events in other years.[29]

Incident to the preparation of excess-profits-tax returns, income of the current year must be classified in accordance with principles previously outlined for the classification of abnormal base-period deductions [30] and any class containing income attributable to prior or subsequent years should be compared with the same class of income for the four previous years or the shorter test period.[31]

Income classifiable in more than one class must irrevocably be included in one of such classes. Any class of income with respect to which the taxpayer did not receive similar income in the test period is abnormal in kind. Any class of income greater than 125 per cent of income of the same class for the test period is abnormal in amount. Each such class of income must be reduced by 125 per cent of the income of the same class for the test period and by direct costs or expenses incurred in the production of such income in order to compute "net abnormal income." [32] The "net abnormal income" in each class must then be allocated to various items in the class and such items must then be apportioned to prior or subsequent years to which they are reasonably attributable.[33] The apportionment of "net abnormal income" to other years must be reasonable in light of all events surrounding the production and receipt of such income. Regulations issued by the Commissioner prescribe the basis for allocating items of income in the six classes noted in the law to the years other than the current year and illustrate the general principles to be followed in similar treatment of other items of abnormal income that is attributable in whole or in part to other years.[34]

Income allocated to years prior to the imposition of the excess-profits tax is not subject to tax, and it does not affect the income of the base period. [35] Income allocated to other years is subject to the tax in such years. In light of

[27] House Report No. 146, I.R.B. 1941–11, pp. 45–46.

[28] Section 721 (a) (3) of the Internal Revenue Code.

[29] Section 721 (b) of I.R.C. and Reg. 109, section 30.721–3.

[30] Regulations 109, section 30.721–2.

[31] Section 721 (a) (1) of I.R.C.

[32] Section 721 (a) (3) of the Internal Revenue Code.

[33] Section 721 (b) of the Internal Revenue Code and Reg. 109, section 30.721–3.

[34] Reg. 109, income from a claim, etc., 30.721–6; income from a long-term contract, 30.721–7; income from property or development of property, 30.721–8; income resulting from change in method of accounting, 30.721–9; income of lessor from termination of lease, 30.721–10; and dividends on stocks of foreign corporations, 30.721–11

[35] For an illustration see Reg. 109, section 30.721–6.

prospective increased excess-profits taxation recognition was given to the fact that the allocation of income to future years might result in hardship rather than relief.[36] In order to obviate this result, the tax on abnormal income allocated to years subsequent to the year of receipt is limited to the tax that would have been imposed if the entire income had been subject to the tax in the year of its receipt.[37]

In order to avoid undue advantages that would result from the application of this section in case corporations should dispose of their properties or liquidate, income otherwise allocable to future years is included in income for the year in which the transfer or first liquidating distribution occurs.[38]

The relief provisions relating to the taxation of abnormal income attributable to activities in other years truly represents the cornerstone of an equitable excess-profits-tax structure.

Abnormalities in the Base Period Meriting Establishing a Constructive Base Period Net Income

Excess profits computed under the income method represent the excess of earnings of the taxable year over earnings for the prescribed normal or base period.[39] The comparison of earnings for years commencing in 1940 and thereafter with earnings for prior years presupposes that operating conditions and the nature and character of the business and operations prior to 1940 present a normal picture or basis for comparison. In our dynamic industrial nation progress and change is the rule. As a result, the character of many businesses changed during the base period and prior to January 1, 1940, to such an extent that income of years prior to the change cannot equitably be used as a measure for determining excess profits in subsequent years. Due to abnormal occurrences such as fires, earthquakes, floods, and strikes, many businesses were unable to operate during all of the base period, with the result that the income experience of the base period cannot equitably be used as a fair standard for determining excess profits.

Congress recognized that relief or special treatment should be accorded in cases where income experience of the base period was not a fair norm or basis for determining excess profits. In order to provide equitable relief, corporations are given the right of establishing a theoretical or constructive income for the base period in certain cases where changes in the character and nature of the business or abnormal interruptions in activities during the base period destroy the value of the income experience of the base period as a norm for determining excess earnings accruing after January 1, 1940.[40] Thus the accountant is given the task of reversing history and of determining what "might have been" if there were no reason for the lament.

In recognition of administrative difficulties attendant on the determination of tax liabilities based on the use of constructive incomes, serious restrictions are placed on the granting of this relief.[41] Thus, taxpayers are not permitted to take advantage of the relief in filing returns,[41] until after the Commissioner has approved or acquiesced in the determination of the constructive base-period income or consented to the use of such constructive income in the prep-

---

[36] House Report No. 146, I.R.B. 1941–11, p. 46.

[37] Section 721 (d); Reg. 109, section 30.721–5, illustrates the application of this limitation.

[38] Section 721 (b) of the Internal Revenue Code.

[39] Section 713 (a). In order to give effect to change in size of corporations the credit used in determining taxable income consisting of 95% of base-period income is increased by 8 per cent of net capital additions and reduced by 6 per cent of net capital reductions.

[40] House Report No. 146, I.R.B. 1941–11, pp. 46–47.

[41] Section 722 (e) of the Internal Revenue Code.

aration of returns.[42] Relief will not be granted unless the excess-profits tax without reference thereto equals or exceeds 6 per cent of normal tax net income,[43] and unless the application of the relief would reduce the excess-profits tax otherwise computed by at least 10 per cent.[44] The application of the relief provision cannot reduce the excess-profits tax below 6 per cent of normal tax net income and the tax computed after the application of the relief section must be increased in an amount equal to 10 per cent of the tax that would have been payable if the relief section had not been applied.[45]

The limitations outlined above materially restrict the number of cases entitled to equitable relief. Some limitation on relief incident to the establishment of a constructive base-period income is essential in order to make such relief administratively workable.[46] Experience may demonstrate that the existing provision does only lip service to a grand and worthy cause, and that the restrictions should be relaxed in order to achieve the intended objective of actually granting relief. The existing section will, however, apply in many exaggerated or severe cases.

The relief actually granted in cases where earnings for the last half of the base period exceed those of the first half [47] will also materially reduce the claims that would otherwise arise under this section. A casual reference to the nature of the relief granted to corporations experiencing greater income in the last half of the base period than in the first half is sufficient to show that abnormal interruption or changes in the character of the business adversely affecting income experience of the first half of the period may actually be beneficial, and accordingly, that no attempt should be made to establish a constructive income unless the establishment of a constructive income increases the excess of earnings of the last half of the base period, over those of the first half. In such cases substantial benefits will result from the application of this section.[48]

There are many instances where relief granted as the result of the establishment of a constructive base-period experience will be very helpful. Thus, a careful survey should be made in all cases where (a) the character of business as at January 1, 1940, is different from the character of the business [49] in one or more of the base-period years, or (b) normal production was interrupted in one or more of the base-period years as the result of some abnormal occurrence [50] in order to construct the average base-period income that would have resulted in case the character of the business had not changed or the abnormal events had not occurred.

The constructive income must be

---

[42] Regulations 109, section 30.722–5 (c).

[43] Section 722 (c) (1).

[44] Section 722 (c) (2).

[45] Section 722 (d).

[46] House Report No. 146, I.R.B. 1941–11, p. 47.

[47] Section 713 (f). In light of this provision interruption of activities in the early years of the base period and changes in the character of business giving rise to greater earnings in the last half than in the first half of the period could be advantageous to the taxpayer.

[48] Under section 722 (b) (4) the average constructive income cannot exceed the constructive income of the last year of the base period. There may be instances where this limitation would reduce the average income computed under 713 (f) without considering the relief granted under section 722.

[49] Under section 722 (b) the character of the business shall be considered to have changed only if —

(a) There is a difference in the products or services furnished; or
(b) There is a difference in the capacity for production or operation; or
(c) There is a difference in the ratio of nonborrowed capital to total capital; or
(d) The taxpayer was in existence during only part of its base period; or
(e) The taxpayer acquired before January 1, 1940, all or a part of the assets of a competitor, with the result that the competition of such competitor was eliminated or diminished.

[50] Section 722 (a).

computed on the premise that none of the items of income were abnormally large and that none of the items of deductions were abnormally small during the base period for which such income is established.[51] Where this relief section is applied, the average base-period income is limited to the constructive income of the last base-period year; in case the last year should be a period of less than twelve months, income for the period is placed on an annual basis.[52]

Applicants for relief under this provision must prepare returns in the ordinary manner and pay taxes reflected to be due thereon until such time as the Commissioner allows the use of the constructive income in the preparation of returns.[53] After filing a return, an application for relief setting forth all information in support of relief claimed must be filed in duplicate with the Commissioner within six months from the time prescribed for filing returns.[54] The application for relief constitutes a claim for refund. If a timely application for relief and claim for refund is not filed, a refund cannot be recovered for the year in question. The taxpayer can, however, obtain some benefit under the section by claiming relief incident to filing a timely petition with the Board of Tax Appeals, or filing a timely protest with the Commissioner in cases where deficiencies in excess-profits tax are proposed. The benefit that can be obtained in the latter cases is limited to deficiencies in excess-profits tax determined prior to the application of relief resulting from the establishment of a constructive base-period income.[55]

Judicious application and administration of the relief granted under sections 711 (b) H to K, 721, and 722 will, in light of relief granted under other sections of the law, alleviate most of the severe hardships normally inevitably encountered in the application of excess-profits-tax laws. Additional flexible relief provisions should be enacted however (a) in cases where the tax is based on inverted capital and income producing assets are excluded from inverted capital and (b) in cases where management salaries or other costs during the current taxable year are abnormally low. In order to avoid serious injustices, excess-profits-tax-relief cases should be handled with dispatch. Machinery for the expeditious handling of cases is provided since questions relating to relief afforded under these three relief provisions are subject to review only by the Board of Tax Appeals.[56] In light of the Board's broad experience in handling tax matters, this should expedite the settlement of excess-profits-tax relief cases.

[51] Section 722 (a) (3) (c).
[52] Section 722 (b) (4).
[53] Section 722 (e); Regulations 109, section 30.722–5 (c).
[54] Section 722 (e) (1) and section 722 (e) (2).
[55] Section 722 (e).
[56] Section 732 of the Internal Revenue Code.

APPENDIX A

Summary of Sections of the Excess Profits Tax Act of 1940 Granting Relief to Taxpayers

1. Section 710 (b) (1) grants all corporations a specific credit of $5,000. This subsection was not amended in March, 1941.
2. Section 710 (b) (3) allowed a limited excess-profits credit carry-over. The unused excess-profits credit for the preceding year was allowed corporations having normal tax net incomes for the taxable year of not more than $25,000. This provision was eliminated and broader relief was granted under section 710 (c) in March, 1941.
3. Section 711 (a) eliminates certain income and deductions not attribu-

table to productive activity in computing excess-profits subject to the tax, and in addition, allows income and defense taxes (other than taxes imposed under section 102) as a deduction in determining taxable excess-profits net income for the current period. This subsection was not amended in March, 1941.

4. Section 711 (b) excludes certain income or profits not attributable to productive activity, together with unusual or nonrecurring deductions in determining base-period excess-profits net income. The section also made provision for the exclusion of all or part of abnormal deductions during the base period resulting from (a) any claim, award, judgment, or decree against the taxpayer or interest thereon, or (b) intangible drilling or development costs pertaining to oil or gas wells or costs of developing mines. The relief granted under this subsection was materially broadened in March, 1941.

5. Section 712 granted all domestic corporations in existence before January 1, 1940, and resident foreign corporations engaging in business in the United States during all or part of each of the taxable years in the forty-eight months preceding the effective date of the excess-profits-tax act, an annual irrevocable election to compute the excess-profits tax credit under either the average base-period-earnings method or the invested-capital method. Under this section, corporations failing to file timely returns were required to compute excess-profits tax liabilities under the invested-capital method. This section was amended in March, 1941, in order to eliminate the necessity of making elections and thus to grant certain domestic and foreign corporations the right to use the greater of the two alternative credits.

6. Section 713 (a) increases the excess-profits tax credit of corporations using the base-period income method of determining tax liabilities in an amount equal to 8 per cent of net capital additions after the commencement of the corporation's first excess-profits tax taxable year, as such additions are defined in section 713 (c), and it provides that the credit shall be reduced by 6 per cent of net capital reductions after that date.

   In substance, the relief granted under this subsection was not revised in March, 1941.

7. Section 713 (b) (5) allows a corporation in existence for only part of the forty-eight months preceding the imposition of the tax to establish a constructive income equal to 8 per cent of invested capital (as adjusted for inadmissibles under section 720) as of the first day of the taxpayer corporation's first taxable year beginning after December 31, 1939, for each full taxable year of the period such corporation was not in existence. The constructive credit must be prorated on a daily basis for any fractional taxable year during which the corporation was not in existence.

   In substance, the relief contained in the above subsection of the original law was not revised in March, 1941.

8. Section 713 (b) (1) to (4) grants an average base-period credit and provides that a loss sustained in any one year of the base period may be treated as zero in computing the average. Thus, in determining average base-period net income, corporations experiencing losses in more than one base-period year disregard the greatest loss sustained in determining aggregate income for the period. The aggregate income for the period is, however, divided by the number of months in the base period and multiplied by 12 in determining the income credit.

   In substance, the relief contained in the above subsection of the original law was not revised in March, 1941.

9. Section 714 allows corporations a credit against current excess-profits net income equal to 8 per cent of average invested capital for the taxable year. This section was not amended in March, 1941.

10. Section 719 allows corporations to include 50 per cent of borrowed capital in invested capital in computing excess-profits tax credits and liabilities. This section was not amended in March, 1941.

11. Section 720 (d) allows corporations to include certain government obligations described in section 22(b) (4) of the Code as admissible assets on condition that income on such government obligations be included in current year excess-profits net income in case this election is exercised. This subsection was not amended in March, 1941.

12. Section 721 allowed corporations to exclude abnormal income of six specified classes attributable to activities or events in other years from income of the current year and to include such excluded amounts in income of the respective years to which they applied. The section also limited the tax liability on income allocated to subsequent years to an amount equal to the tax that would have been imposed if the taxpayer had not taken advantage of the relief provided in the section. The relief provided in this section was broadened to include abnormal net income of any class in the March, 1941, amendments.

13. Section 722 granted the Commissioner broad authority to make any adjustments necessary to adjust abnormalities affecting income or invested capital. This section was too vague to be of value and it was completely rewritten in the March, 1941, amendments.

14. Section 723 prescribes an equitable basis for determining capital when historic data relating to equity-invested capital are not available. This section was not amended in March, 1941.

15. Section 724 allows certain foreign corporations to determine invested capital with reference to the average daily tax basis of United States assets. There are many cases where foreign corporations will be given preferential treatment over domestic corporations under this section unless invested capital is determined with reference to net United States assets and the usual consideration is given to United States borrowed capital. This section was not amended in March, 1941.

16. Section 725 gives personal-service corporations an annual election to avoid the tax by electing to be classified as partnerships for excess-profits tax purposes. This section was not amended in March, 1941.

17. Section 726 places a limitation on the tax imposed on corporations completing contracts subject to provisions of section 505 (b) of the merchant-marine act of 1936, as amended. The tax cannot exceed the lower of the regular excess-profits tax or the excess of a tentative tax computed under section 710 on income including payments to the Maritime Commission over the amount of such payments. This section was not amended in March, 1941.

18. Section 727 exempts certain corporations from the tax. This section was not amended in March, 1941.

19. Section 729 (b) exempts corporations having excess-profits net incomes (computed under the invested-capital credit) of $5,000 or less from filing excess-profits tax returns. The relief granted under this subsection was not amended in March, 1941.

20. Section 730 grants affiliated corporations the privilege of electing to file consolidated returns. This

section was broadened in the March, 1941, amendments in order to remove certain restrictions relating to the right of insurance companies to file consolidated returns.

21. Section 731—Any income derived by domestic corporations from activities carried on within the United States in the mining of certain strategic metals; i.e., tungsten, quicksilver, manganese, platinum, antimony, chromite, or tin, is exempt from the excess-profits tax. Section 206 of the House Bill H. R. 5417 makes this provision inapplicable to taxable years beginning after December 31, 1940. This section was not amended in March, 1941.

22. Sections 740 to 743 set forth both favorable and unfavorable provisions relating to the determination of tax on reorganized corporations. The provisions of the original bill were analyzed by J. S. Seidman in his article "The Exchange Provisions of the Excess-Profits Tax Law" (*Taxes—The Tax Magazine* for February, 1941).

APPENDIX B

Summary of Sections of Excess Profits Tax Act of 1940, as Amended in March, 1941, Granting Relief to Taxpayers

1. Section 710 (b) grants all corporations a specific exemption of $5,000.

2. Section 710 (c) allows all corporations to carry over unused excess-profits credits into the two succeeding taxable years with a resulting leveling off of incomes affected by fluctuations in earnings. The unused excess-profits credit represents the excess of the credit over the excess-profits net income. In case H. R. 5417 is enacted the excess-profits credit carry-over for 1941 and subsequent years will be substantially reduced since the carry-over will have to be computed under the 1941 act. Under the 1941 act the invested-capital credit is reduced from 8 per cent of the total invested capital to 8 per cent of the invested capital not in excess of $5,000,000 plus 7 per cent of the excess (exclusive of "new capital" invested subsequent to December 31, 1940, with respect to which the aforesaid credit will be increased 25 per cent), and the credit based on income is revised since the income taxes are not allowed as deductions in computing the average base-period net income. The new provisions will result in decreasing the credit carry-over under both methods: (a) if the excess-profits credit is based on the invested capital, the excess-profits credit carry-over will be reduced in an amount equal to the income taxes disallowed in excess-profits tax taxable years giving rise to the credit carry-over plus the reduction in the invested-capital credit for those years, and (b) if the excess-profits credit is based on income, the excess-profits credit carry-over will be reduced in an amount equal to the excess of income and defense taxes in the excess-profits tax taxable years serving as the base for the credit carry-over, over the average of such taxes in the base-period years.

3. Section 711(a) eliminates certain income and deductions not attributable to productive activity from the base of the tax, and in addition, allows income and defense taxes (other than taxes imposed under section 102) as a deduction in determining excess-profits-tax income for the current period. The Senate and House drafts of H. R. 5417 amend this section in order to eliminate income taxes as a deduction for current periods in computing excess-profits tax net income. The excess-profits tax will, however, with certain limitations, be allowed

as a deduction in computing the normal tax. If this proposal is finally enacted, excess-profits taxes will be substantially increased.

4. Section 711(b) excludes certain income and profits not attributable to productive activity, together with unusual or nonrecurring deductions in determining base-period excess-profits net income and makes provision for the exclusion of abnormal deductions in determining base-period excess-profits net income, despite the fact that such deductions are allowable in computing excess-profits subject to tax for all years during which the excess-profits tax is in force.

5. Section 712 grants all domestic corporations which were in existence before January 1, 1940, and resident foreign corporations engaging in business in the United States during all or part of each of the taxable years in the forty-eight months preceding the effective date of the excess-profits-tax act, alternative credits based on average base-period income or invested capital and provides that the tax will be computed under the credit resulting in the lowest tax unless the taxpayer specifically elects to disclaim the use of one of the credits. The disclaiming of one of the credits obviates the necessity compiling data in support thereof.

6. Section 713 (a) increases the excess-profits-tax credit of corporations using the base-period income method of determining tax liabilities in an amount equal to 8 per cent of net capital additions after the commencement of the corporation's first excess-profits-tax taxable year, and provides that the credit shall be reduced by 6 per cent of net capital reductions after that date, as such additions and deductions are defined in section 713 (g).

7. Section 713 (d) allows a corporation in existence for only part of the forty-eight months preceding the imposition of the tax to establish a constructive income equal to 8 per cent of invested capital (as adjusted for inadmissibles under section 720) as of the first day of the taxpayer corporation's first taxable year beginning after December 31, 1939, for each full taxable year of the period such corporation was not in existence. The constructive credit must be prorated on a daily basis for any fractional taxable year during which the corporation was not in existence.

8. Section 713 (e) grants an average base-period credit and provides that a loss sustained in any one year of the base period may be treated as zero in computing the average. Thus, in determining average base-period net income, corporations experiencing losses in more than one base-period year disregard the greatest loss sustained in determining aggregate income for the period. The aggregate income for the period is, however, divided by the number of months in the base period and multiplied by 12 in determining the income credit.

9. Section 713 (f) grants corporations experiencing an increase in income during the last half of the base period an additional method of determining the income credit. Under this method, the income credit is determined by first computing the excess of earnings of the last half of the base period over those of the first half. One-half of such excess is added to the income for the last half of the base period. The sum is then divided by the number of months in the last half of the period and then multiplied by 12 in order to produce an annual base-period credit. In making this computation, all losses are taken into consideration. Thus, corporations experiencing losses or very low earnings in the first half of the period are granted a substantial advantage over corporations having stable earnings. Subdivision 7

of section 713 (f), however, requires corporations having fiscal years ending after May 31, 1941, to substitute an assumed normal income for income deemed attributable to months ending after May, 1941.

10. Section 714 allows corporations a credit against current excess-profits tax income for the purpose of computing the tax or the credit carry-over equal to 8 per cent of invested capital for the taxable year. In case the House or Senate drafts of H. R. 5417 are enacted, the credit will be revised to 8 per cent of invested capital not in excess of $5,000,000 and 7 per cent of invested capital in excess of $5,000,000. In order to encourage additional capital investments new equity-invested capital in years beginning after December 31, 1940, subject to certain limitation, will be increased to 125 per cent thereof in determining equity-invested capital.
11. Section 719 allows corporations to include 50 per cent of borrowed capital in invested capital in computing the excess-profits-tax credit based on invested capital.
12. Section 720 allows corporations to include certain government obligations described in section 22 (b) (4) of the Code as admissible assets on condition that income on such government obligations must be included in current year income in case this election is exercised.
13. Section 721 allows corporations to exclude net abnormal income attributable to activities or events occurring in other years in determining excess-profits for the current year and limits the tax liability on income allocated to subsequent years to an amount equal to the excess-profits tax that would have been payable if the taxpayer had not taken advantage of the relief afforded by this section.
14. Section 722 provides a basis for general relief in cases where the character of business engaged in as of January 1, 1940, is different from the character of business engaged in during one or more of the base-period years or in case normal production or operations were interrupted or diminished due to the occurrence of abnormal events during one or more of the base-period years. Where either of the above conditions exist, taxpayers are entitled to establish a constructive income credit for the base period. Serious limitations are imposed on the relief granted under this section in order to make the section administratively workable.
15. Section 723 prescribes an equitable basis for determining capital when historic data relating to equity-invested capital are not available.
16. Section 724 allows certain foreign corporations to determine invested capital with reference to the average daily tax basis of United States assets. There are cases under this section where invested capital for excess-profits-tax purposes will materially exceed the corporation's actual invested capital unless invested capital for tax purposes is based on net United States assets and not on gross United States assets.
17. Section 725 gives a personal-service corporation an annual election to avoid the tax by signifying on its income-tax return its desire to be classified as a partnership for excess-profits-tax purposes.
18. Section 726 places a limitation on the tax imposed on corporations completing contracts subject to provisions of section 505 (b) of the merchant marine act of 1936, as amended. The tax cannot exceed the lower of the regular excess-profits tax or the excess of a tentative tax computed under section 710 on income including payments to the Maritime Commission over the amount of such payments.
19. Section 727 exempts certain corporations from the tax.

20. Section 729 exempts corporations having excess-profits net incomes for the current year (computed under the invested-capital method), of not more than $5,000, from filing excess-profits tax returns.
21. Section 730 grants certain affiliated corporations the privilege of electing to file consolidated returns.
22. Section 731—Income derived from mining activities carried on within the United States for mining certain strategic metals; i.e., tungsten, quicksilver, manganese, platinum, antimony, chromite or tin is exempt from the excess-profits tax. Section 206 of the House Bill, H. R. 5417, makes this provision inapplicable to taxable years beginning after December 31, 1940.
23. Section 733 gives taxpayers an election to capitalize certain expenses for advertising or promoting goodwill which were deducted in the base period. As a condition to capitalizing such expenditures, however, the taxpayer must pay a tax equal to the base-period income tax that would have been assessed if such expenditures had not been deducted, and interest thereon, and in addition, similar expenditures must be capitalized in all future excess-profits-tax taxable years. Experience with prior excess-profits taxes has demonstrated that the imposition of high taxes encouraged the incurrence of high advertising expenditures and other expenditures designed to benefit businesses over a long-range period. Any taxpayer electing to capitalize advertizing and goodwill promotional expenses during the base period must make an election to do so within six months from the date prescribed for filing its first excess-profits-tax return. In case such an election is made, the taxpayer will be deprived of the opportunity of deducting advertising and other expenses for the long-range promotion of business or goodwill during the period the excess-profits-tax law is in force. Thus, it is apparent that the relief, if any, granted under this section must be purchased at a high price.
24. Section 734 grants corporations limited relief in case the Commissioner adopts an inconsistent position, for excess-profits-tax purposes, from that adopted in determining prior-year income-tax liabilities. This section also imposes serious burdens on taxpayers taking an inconsistent position.
25. Sections 740 to 743 set forth both favorable and unfavorable provisions relating to the determination of tax on reorganized corporations. The provisions of the original bill were analyzed by J. S. Seidman in his article "The Exchange Provisions of the Excess-Profits Tax Law" (*Taxes—The Tax Magazine* for February, 1941). The most serious objectionable provisions of the original bill which Mr. Seidman called attention to were eliminated in the March, 1941, amendments to the law. Under the 1941 amendments, corporations acquiring the assets and business of partnerships or sole proprietorships are, under certain circumstances, permitted to include the income experience of such partnerships or sole proprietorships in determining base-period income (see section 740 (h)). Acquiring corporations actually in existence before January 1, 1940, are given the election of excluding or including the income experience of component corporations under the income method (see section 742 (a)).

APPENDIX C

Summary of Changes in the Existing Law Proposed in H. R. 5417 as Approved Respectively by the House and Senate

The revenue act of 1941 does not materially modify the excess-profits-tax structure which was established under the second revenue act of 1940. The new law makes several significant changes for the purpose of raising additional revenue, which do not alter the basic structure of the system for taxing excess profits. The principal new provisions amend the existing law by:

(a) Increasing tax rates.
(b) Reducing the invested-capital credit on corporations having an invested capital in excess of $5,000,000.
(c) Increasing excess-profits-tax net income by disallowing the normal tax as a deduction.
(d) Reducing the excess-profits-tax credit carry-over as a result of the reduction of the excess-profits-tax credit on the invested-capital basis and as the result of disallowing normal taxes as a deduction in computing excess-profits-tax net income.
(e) Placing a premium on additional capital investments as a result of increasing invested capital in the amount of $125 for every $100 of "new capital" invested in corporate enterprises.

The amendments to the excess-profits-tax structure are applicable to taxable years beginning after December 31, 1940.

Following is a summary of the principal amendments to the excess-profits-tax law that have been approved by the Senate and the House:

1. Section 201 (a) amends Code section 710 (a) in order to increase rates of tax. The new rate schedule increases the tax rate on each bracket of adjusted excess-profits net income by ten percentage points. The new rate schedule is as follows:

Adjusted Excess-Profits Net Income			*New Tax Rate*
Not over	$20,000		35%
Over	$ 20,000 but not over	$ 50,000	40%
Over	50,000 "	100,000	45%
Over	100,000 "	250,000	50%
Over	250,000 "	500,000	55%
Over	500,000		60%

2. Section 201 (b) amends Code section 714 in order to reduce the invested-capital credit. The invested-capital credit is reduced from eight per cent on all invested capital, to eight per cent of the first $5,000,000 of invested capital, plus seven per cent of the remainder.

3. Section 202 (a) amends Code section 23 (c) in order to increase excess-profits-tax net income. Under this amendment, the corporation normal tax is not allowed as a deduction in computing excess-profits-tax net income. The excess-profits tax is, however, allowed as a deduction in computing net income subject to normal taxes and surtaxes (other than declared value excess-profits taxes), subject to the following limitations:

   (a) The amount of the excess-profits tax is not reduced by allowable foreign tax credits.
   (b) The excess-profits-tax deduction represents the tax before making any adjustments thereto under the provisions of section 734 of the Code by reason of an inconsistent position taken by the taxpayer or the Commissioner in computing ex-

cess-profits taxes and normal income taxes.

(c) The excess-profits tax based on a consolidated return must be apportioned among members of the affiliated group under regulations issued by the Commissioner.

(d) The excess-profits tax is deductible for the year in which the tax accrued regardless of whether the taxpayer renders returns on the cash or accrual basis.

4. Section 202 (c) amends Code section 711 (a) in order to eliminate the normal tax as a deduction in computing excess-profits net income.

5. Section 202 (d) amends Code section 711 (a) in order to increase deductions limited by net income so that the limitation for excess-profits-tax purposes will be based on net income before deducting excess-profits-taxes. This amendment was necessary inasmuch as deductions, for normal-tax purposes, limited to a percentage of net income must be computed on income after deducting excess-profits taxes.

6. Section 202 (e) amends Code section 710 (c) in order to reduce the excess-profits credit carry-over. Under this section, the taxpayer's base-period net income, invested-capital credit, and excess-profits-tax net income for its first excess-profits-tax taxable year must be computed under the law applicable to taxable years beginning after December 31, 1940; thus, income taxes will not be allowed as a deduction in computing the income credit for the base-period or excess-profits net income for the taxpayer's first excess-profits-tax taxable year. This will result in decreasing the excess-profits credit carry-over in an amount equal to the excess of income and defense taxes in the first excess-profits-tax taxable year over the average of such taxes in base-period years where the carry-over is computed under the income method. The credit carry-over will be reduced in an amount equal to income and defense taxes of the first excess-profits-tax taxable year which are disallowed in cases where the excess-profits credit carry-over is computed on the invested capital basis.

7. Section 202 (h) amends Code section 602 in order to disallow excess-profits taxes as a deduction in the computation of the declared value excess-profits tax.

8. Section 203 amends Code section 718 (a) so as to grant a bonus of 25 per cent on new capital invested during taxable years beginning after December 31, 1940. In order to minimize the higher credit allowance for new capital, the term "new capital" is rigidly defined.

9. Section 202 (f) amends Code section 718 (c) relating to the computation of earnings and profits. Under this provision the income tax for the taxable year is not deducted from earnings and profits in determining whether a distribution is made out of earnings and profits of the taxable year.

10. Section 202 (g) amends Code section 722 (c) relating to abnormalities in the base period and provides that relief shall not be granted unless the special relief reduces the tax below 6 percent of normal tax net income before deducting the excess-profits tax.

11. Section 204 amends Code section 731 in order to impose excess profits on income derived in years beginning after December 31, 1940, from mining certain strategic metals in the United States.

Some Problems of Invested Capital under the 1940–1941 Excess Profits Tax

BY FREDERICK L. PEARCE, WASHINGTON, D. C.
Associate, American Institute of Accountants

WE HAVE as the topic for our consideration this morning some of the problems involved in the determination of invested capital under the 1940–1941 excess-profits tax. The time assigned will not permit an examination of questions in regard to foreign corporations, and our discussion will be limited to some of the invested-capital problems of the general class of taxable domestic corporations. From the present attitude of Congress and of the administrative officers recommending tax legislation, it seems likely that this excess-profits tax will be with us for a long time; and hence it is worthy of the most careful study by members of our profession.

As a background for the present discussion, it should be helpful to summarize the legislation by which this tax is imposed. As you all know, there was added to the federal taxing system, by the second revenue act of 1940, a new type of corporate excess-profits tax, applicable to all taxable years beginning after December 31, 1939. This new tax appears in Chapter 2 of subtitle A of the Internal Revenue Code (relating to additional income taxes), as Subchapter E (excess-profits tax), in sections numbered from section 710 upward (not beyond section 799).

The initial statute, however, was retroactively amended, in legislation enacted on March 7, 1941, before the first of these excess-profits tax returns became due. Thus, the original act with the March, 1941, amendments applies generally to the 1940 calendar-year returns and to the 1941 fiscal-year returns, many of which are yet to be filed and, of course, except as amended will continue to apply to returns for later years.

Also, at the present time, Congress has under active consideration as part of the revenue act of 1941, further amendments to this excess-profits tax, which are stated to be applicable for taxable years beginning after December 31, 1940. Hence, unless there be a change in principle before that statute is finally enacted, the pending amendments to the Code will apply only to the excess-profits tax returns for the calendar year 1941 and for fiscal years ending in 1942 (and for later years, unless the statute be further amended).

While the changes proposed in the 1941 revenue act are quite substantial as to this excess-profits tax generally, thus far only one change has been presented in regard to invested capital. The proposal is that a subsection be added (as section 718 (a) (6) of the Code) to grant an extra addition to invested capital of 25 per cent (or in effect a total of 125 per cent) for new equity capital invested during a taxable year beginning after December 31, 1940. The factor of 125 per cent is to be prorated for the effective period in the year in which the new capital is paid in. But apparently the whole of such 125 per cent is to be accumulated as invested capital for subsequent taxable years.

Consequently, unless further changes be proposed, which have thus far not been suggested, the provisions for invested capital, except for this "new capital" addition, will be the same under the 1941 act as for 1940. This obviously helps to simplify our present consideration, since all that is to be said in regard to invested capital for 1940 will be equally applicable under the 1941 act (by merely adding 25 per cent when the new capital factor applies).

By way of further introduction it seems desirable to note the part which invested capital plays in the general plan of this excess-profits tax. What the statute really provides for, is in practical effect two distinct and separate methods for determining what are excess profits subject to this tax. In the first alternative, the excess is over a credit measured in relation to the earnings of a prior base period. In the second method, the excess profit is the amount above a credit based upon a percentage of invested capital.

It should be remembered also that the excess-profit credit (based upon invested capital) is a purely statutory allowance granted by Congress, but for which a greater tax would be imposed. Because of this, the credit, and the invested capital upon which it is based, rest solely upon the grace of Congress and not upon any fundamental or constitutional right. As a consequence we do not have here the net worth or paid-in capital in the ordinary sense of corporation law, which must be granted as a matter of right, but we have an invested capital which is purely a concept of the revenue statute. This fundamental of statutory source must be borne in mind in any consideration of the problems of invested capital.

While the credit percentages may vary from year to year (a credit of 8 per cent of invested capital for 1940; and of 8 per cent on the first $5,000,000 and 7 per cent on the remainder proposed for 1941) the essential definition of invested capital thus far remains the same. Only a "new capital" factor is added for 1941. Hence, once the invested capital of a domestic corporation is determined for the first year under the 1940 act, it is necessary merely to carry forward the year's adjustments to reach the invested capital for the next year. Further, unless more radical changes be made in future legislation, the same cumulative process should be effective for computing invested capital for 1942 and later years.

As a consequence in the case of a domestic corporation, the invested capital to be computed for the first year under the 1940 act is the essential starting point, as well for 1941 and probably also for later taxable years. It should be remembered, however, that an entirely different method of computing invested capital is provided for foreign corporations doing business in the United States, and for corporations operating in our possessions (that come under section 251 of the Code).

Invested capital of a domestic corporation (for 1940) is defined in sections 715 to 720, inclusive, and section 723, of the Internal Revenue Code. In summary, the invested capital is an aggregate of three factors: the equity-invested capital, plus (one half) the borrowed invested capital, and less the adjustment for "inadmissible" assets. Upon an analysis of these sections, however, it appears that the first covers all that might be called "permanent" or cumulative invested capital, while the latter two are, in essence, merely annual adjustments that arise within, and affect, but a single year. It may be worth repeating that the figures for borrowed capital and the inadmissible adjustment have to be determined separately for each year's invested capital and do not accumulate from year to year. Because of this, the present discussion will be directed primarily to the specifications covering the equity, or more permanent invested capital.

Equity-invested capital is defined in section 718 of the Internal Revenue Code (with a supplementary provision in section 723 to cover special cases in which the usual determination cannot be made under section 718). In regard to most of the specific items usually entering into invested capital, that section does not formally distinguish between those arising in prior years and those occurring in the current taxable year. In the practical process of computing invested capital, however, it is much more preferable to set up initially the figures as of the beginning of the first taxable year under the 1940 act. That is the practical starting basis to be adjusted for the changes in invested capital occurring within the year. Also, and probably more important, the equity-invested capital at the start of the first year (1940) is the basic figure to which further accumulations of equity adjustments may be added to reach the corresponding figure for the start of the next year (1941). Further, as previously mentioned, unless the statute be radically amended, the basic invested capital for 1942 and later years may be reached by continuing the cumulative process.

What then comprises this basic figure, the equity-invested capital as of the start of first excess-profits-tax year? In short, it consists of several elements, each of which may include a number of sub-items. The elements, as set out in section 718, are, in summary, cash and property paid in as capital, any earnings capitalized in prior taxable stock dividends, the accumulated earnings and profits, less any prior distributions out of capital, and with adjustments for certain prior tax-free transactions (principally liquidations of subsidiary corporations). A further sub-analysis of each element is necessary, however, in the actual determination of equity-invested capital.

The initial group is money and property previously paid in to the corporation for stock, or as paid-in surplus, or as a contribution to capital. Even cash paid in may present some problems, if stock is sold at less than par. If the reduction represents a selling commission, that may go into invested capital. But if the lower price represents merely a discount on the issue, the lower figure is more likely to be used.

Property paid in is to be included, in the equity-invested capital, at the income-tax basis (unadjusted) for determining loss. The Regulations (Reg. 109, Sec. 30.718–1) say that this means the basis under the law applicable to the year for which the invested capital is being computed, and not the basis under the act in force at the time the property was paid in. Further, even if the property so paid in has long since been disposed of, it is to be included with the same basis as though it had been retained. Any change due to a prior loss, destruction, or disposition of such property will be reflected in the figure for accumulated earnings and profits.

Thus, to determine the first element of equity-invested capital, it is necessary to trace the fiscal history of the taxpayer back to its organization, and even farther back through its predecessors, if the present company has acquired property in any merger, reorganization, or typically tax-free transaction for which a substituted basis is provided. One must ferret out each item or lot of property which has at any time been paid in as capital; examine the surrounding circumstances; and determine the basis thereof under the current income-tax statute. Thus we have involved here every problem of basis including, frequently, the valuation of property or stock on more or less remote dates. Obviously, the par of the outstanding capital stock is not the test, but what was paid in for it.

It may be well to strike at this point a note of caution as to any figure to be used in invested capital. In the March, 1941, amendments, section 734 was inserted in the Internal Revenue Code. This provides in substance that, where, in the determination of the excess-profits tax, any item is treated in a manner inconsistent with its treatment for tax purposes in a prior (barred) year, the tax for such prior year shall be recomputed and any increase added (with interest) to the excess-profits tax for the current year (a similar decrease to be deducted with interest). This provision also applies to inconsistent treatment of items by "predecessors" of the present taxpayer. One can readily conceive of many instances in which such prior tax, with interest, may greatly exceed the reduction in excess-profits tax resulting from a current inconsistent treatment of typical items. Because of this, it is necessary also to check the prior tax treatment of all substantial items, and avoid inconsistencies in the current determination of equity-invested capital.

The practical process, obviously indicated, to set up the paid-in equity capital, is to analyze the capital accounts. Starting with the organization of the corporation, the capital-stock accounts should be examined, and each issuance (or redemption) of stock should be separately tabulated. Where property was paid in, extrinsic evidence, outside of the books of account, will probably have to be considered to determine the income-tax basis (under the current statute) of the property that was paid in.

In regard to stock repurchased or redeemed, it should be noted that the amount of the reduction is presumably the repurchase (cost) price and not the invested capital set up when the same stock was issued. The redemption is considered to be a distribution not out of earnings, and hence the repurchase price is the amount of the distribution.

If a repurchase of stock has been treated under prior income-tax statutes as "essentially the equivalent of a taxable dividend" (Sec. 115 (g), of the Code) then the redemption should be considered to be the same as a dividend and not as a capital distribution. This is important, since invested capital is reduced for the whole amount of a capital distribution, while a dividend may work into a subsequently accumulated deficit. Capital stock returned to the corporation as a gift or as donated stock, apparently has no effect upon the invested capital, since there is nothing to constitute a distribution.

Where separate paid-in or capital-surplus accounts are maintained, a similar analysis of those is, of course, called for. In addition, all general surplus accounts should be similarly checked for items of paid-in capital. Also, if the present company had a business predecessor or resulted from a merger or consolidation, the same process should be followed through an examination of the prior accounts of all predecessors.

As a practical suggestion each summary schedule might be prepared in three columns: the first to show the book figure; the third to show the basis or invested-capital amount; and the middle column to carry a balancing or adjustment figure to keep control of differences. Also, since the changes in the current year must be prorated for the number of days effective, they might be tabulated separately from the general summary, totalled to the beginning of the taxable year.

The second element of equity capital, comprises taxable stock dividends that represent a capitalization of prior earnings. Obviously these items will turn up in the analysis of the capital-stock (and surplus) accounts, and for practical purposes they will usually not need to be entered into a separate schedule. The Regulations (Reg. 109, Sec. 30.718–3) point out, however, that this provision refers only to stock dividends that were taxable to the recipients, and that nontaxed stock dividends do not reduce earnings and profits. Hence, if there is a deficit, any nontaxed stock dividends must be removed from the stock accounts and treated as part of earnings and profits.

A nice question arises where there was an accumulation of earnings and profits at the time that a taxable stock distribution was made, but subsequent losses have produced an operating deficit at the beginning of the taxable year. From the form of the present statute, it seems rather clear that, in such a case, the amount of the taxable stock dividend remains in invested capital, while the subsequently accumulated deficit is not to be used as a reduction. Further, in such a case, even if some of the stock has been donated back to the company to wipe out the deficit, it would seem, nevertheless, that the total amount of the taxed stock dividend remains in invested capital.

A further element of equity-invested capital is designated as the accumulated earnings and profits as of the beginning of the taxable year. This is actually a rather inclusive aggregate of items which in the general run of cases is likely to give the auditor some difficulty. The Regulations (Reg. 109, Sec. 30.718–2) state that in general the concept of accumulated earnings and profits for the purpose of the excess-profits tax is the same as for the income tax. In regard to the latter, it has been frequently held that earnings of a corporation coincide generally with concepts for determining taxable net income.

If an item is not recognized as income, appreciation merely written up on the books, for example, it is not to be included in accumulated earnings. On the other hand, an item that is truly income even though not taxable, such as tax-exempt interest, is to be included in the accumulated earnings. Similarly, as to negative items, if the charge-off is in no sense a deduction, such as, for illustration, a write-down of the value of land or goodwill, it does not reduce the accumulated earnings. On the contrary, however, if there is a real outgo or loss, such as nondeductible donations or a capital loss in excess of the $2,000 deductible limit, the accumulated earnings are nevertheless to be reduced thereby.

As you all know, there was inserted in the second revenue act of 1940, section 501, which adds (as subsections (l) and (m)) to section 115 of the Internal Revenue Code, a partial definition of earnings and profits. While the language used is rather involved, and a generalization may be inaccurate, the essence of the provision appears to be this. Gain or loss which is realized but not recognized for tax purposes does not enter into the computation of accumulated earnings and profits. Also, a distribution which effects a reduction or division of the basis of the stock on which the distribution was made, does not go into earnings of the recipient. However, a realization of March 1, 1913, appreciation, through a disposition of the property, does add to the accumulated earnings.

The Treasury Decision (No. 5,024) interpreting this provision states that losses disallowed as deductions under sections 24 (b), 117 and 118, nevertheless do reduce the accumulated earnings and profits. The losses referred to, in transactions with related interests, capital losses, and losses on wash sales are, of course, actually realized losses. As to wash-sale losses, however, the provision for the adjustment of basis for later disposition (section 113 (a) (10)) will result in a second reduction in earnings, unless a reverse adjustment is made for the first or second disposition.

Subsection (h) of section 115 of the Code provides in substance that distributions which are not recognized as income to the recipients, are not to be treated as distributions of earnings by the distributing corporation. The Regulations (Reg. 103, Sec. 19.115–11) point out that this provision relates generally to four types of distributions, i.e., distributions in pursuance of a plan of reorganization, in a complete liquidation (section 112 (b) (6) of the Code) of a subsidiary, in a utility case in obedience to orders of the Securities and Exchange Commission, and untaxed stock dividends. Obviously such items must be sought out and identified, in any analysis of the accumulated earnings and profits.

A practical procedure for the determination of the accumulated earnings and profits might be suggested somewhat as follows. As you all know, we have had for some years, in the corporation-income-tax return, the so-called Schedule L; a reconciliation of book income and surplus, with the taxable net income and surplus on a tax basis. These schedules for the respective years, amplified with the adjustments made in the final settlement of the tax, where there has been a change, should supply practically all the required information. With these data it should not be too difficult to prepare a running analysis of surplus, starting with book figures and adjusting the accumulated earnings and profits to a tax basis.

Time will permit of merely a further mention of some of the factors to be kept in mind in preparing a schedule of accumulated earnings. It must be remembered that, for tax purposes, surplus reserves are a part of earnings. For example, if the company uses the direct charge-off of bad debts, then any reserve for bad debts is a surplus reserve. However, if the corporation is deducting the addition to the reserve, then it is a valuation reserve and not a part of surplus.

Typical items which may increase the accumulated earnings are: depreciation upon March 1, 1913, value in excess of cost, discovery or percentage depletion in excess of depletion upon cost, life insurance paid to the corporation on the death of the insured, assets previously written off when not deductible, such as goodwill, organization expense, write-down of securities, etc., net additions to surplus reserves, and in general deductions previously disallowed such an excessive depreciation, taxes assessed for local benefits, or repairs treated as capital expenditures for tax purposes.

Typical items which may decrease the accumulated earnings and profits are: federal income taxes paid or claimed as a credit, dividends paid out of earnings including taxable stock dividends, nondeductible donations, capital losses in excess of the $2,000 limitation, loss in transaction with related interest (section 24 (b) and (c) of the Code), losses on wash sales (the substituted securities still owned), interest paid to carry tax-exempt bonds, additional deductions claimed and allowed in prior tax adjustments, and life-insurance premiums where the corporation is the beneficiary. As to the last item, under the excess-profits-tax acts of the last war (1917 through 1921), the premiums were disallowed but the cash-surrender value was included in the invested capital. In other words, only the excess of the annual premium paid over the increase in cash-surrender value, represented a reduction of accumulated earnings.

In dealing with earnings and profits, the decisions in regard to the amounts available for the payment of dividends would seem to be equally controlling for purposes of invested capital. Just as a word of caution, remember that when a deficit seems to be indicated, the earnings figure should be determined at each dividend date, to ascertain if any part was paid out of capital. Further, it should be recalled that, beginning with the calendar year 1936, dividends, irrespective of the date of payment, are to be charged against the whole of the year's earnings. In this connection, it should be remembered that many corporations have heretofore secured authoritative determinations of the earnings available for the payment of dividends at least up to certain dates. Any such, that can be found, will naturally be of great aid in computing the accumulated earnings and profits for invested-capital purposes.

In conclusion, I might refer to a request, made at a tax discussion about a year ago, for a statement of the essence of equity-invested capital in one sentence. If that is possible, it will be found in section 723, the alternative provision to be applied when the determination cannot be made under section 718 by the regular accumulative method. Under section 723, equity-invested capital as of the beginning of the first taxable year under the 1940 act, is in essence defined as net worth ascertained from a balance-sheet prepared upon an income-tax-cost basis. That also seems to be the fundamental concept underlying the provisions of section 718. If that principle is kept in mind, it will be of material aid in following through the adjustments in a determination of equity-invested capital.

Cancellation of Indebtedness and Its Effect upon Income Taxes

BY ERIK C. BOYE, ST. LOUIS, MO.
Member, American Institute of Accountants

INSTANCES are rare in which a tax point of controversy has been completely clarified by a single decision. Most frequently, case after case, involving the same point of controversy, has been presented to the Board and to the Courts before something like a general rule has evolved. Oftentimes statutory amendments have been necessary to fix more definitely general rules established by decisions or to reach equitable solutions of income-tax questions in given types of cases.

This is also true as relates to the tax position of the debtor in instances of cancellation or forgiveness of indebtedness. During the early existence of the Board of Tax Appeals the question arose in the case of the *Meyer Jewelry Company*, 3 B.T.A. 1319, as to whether cancellation of indebtedness constituted taxable income. In that case the debtor, financially embarrassed, reached a composition settlement with its creditors whereby the latter agreed to accept 60 cents on the dollar in complete settlement of their accounts. The report in that case does not indicate that any definite evidence was presented as to the insolvency of the debtor. Nevertheless, the Board found that no income had resulted from the cancellation. Other and similar decisions followed in cases where the facts as to the solvency and insolvency of the debtors were not clear, and for a time taxpayers and practitioners alike were, perhaps, too prone to conclude that a general rule had been established, namely: that cancellation of indebtedness did not result in taxable income.

In 1931 the Supreme Court in its decision in the case of *Kirby Lumber Co.*, 284 U.S. 1, laid down the principle that taxable income resulted from cancellation of indebtedness in instances where there had been a freeing of assets. This the Supreme Court expressed in the following terms:

"Here there was no shrinkage in assets and the taxpayer made a clear gain. As a result of its dealings it made available $137,521.30 assets previously offset by the obligation of bonds now extinct."

It will be recalled that the *Kirby Lumber Co.* had retired its own bonds purchased at less than the issue price and that the question arose—if taxable income had been realized in the amount of the difference between the issue price and the purchase price.

Thereafter in cases involving the question of taxability of cancellation of indebtedness, facts relating to the solvency or insolvency of the debtor began to play a prominent part in decisions. Indeed, decisions began to turn entirely upon whether, or not, the debtor was solvent or insolvent, and there emerged the general rule that if indebtedness of a solvent debtor is cancelled or forgiven (in whole or in part) the debtor realizes income in the amount of the indebtedness cancelled and there evolved also the counter rule that if the debtor is insolvent and remains in that state after the cancellation then no income is realized.

Up to the time of the decision by the Board (1937) in the case of *Lakeland Grocery Co.*, 36 B.T.A. 289, all of the cases involving income from cancellation of indebtedness concerned debtors who were either solvent or insolvent both before and after the cancellation. That case presented the intermediate situation where the taxpayer was insolvent before the composition settlement but became solvent as a result of the forgiveness. In connection with the cancellation of indebtedness in the amount of $89,237.55 by its creditors the *Lakeland Grocery Co.* was permitted to retain net assets in the amount of $39,596.93. The Commissioner contended that the taxpayer had realized taxable income in the full amount of indebtedness cancelled, but the Board, in its decision, limited the amount of such income to $39,596.93, which was the amount of assets freed from the claims of creditors.

While the rule thus is that a solvent debtor realizes taxable income from the cancellation of indebtedness, such rule is only a general rule and it therefore becomes necessary to examine the nature of the transaction to determine if any given cancellation falls within or beyond this rule.

Cancellation of indebtedness may be prompted by different motives and may take on many forms. Particular motives and particular forms may have mitigating effects upon the recognition of income. Thus the cancellation of principal amounts of indebtedness (not including interest, salary, etc.) of a corporation by a majority stockholder has repeatedly been held to constitute additional cost of stock to the stockholder and to result in no income to the corporation. From the same decisions, it would appear also that cancellation of similar corporate indebtedness, in connection with recapitalizations, either for the purpose of anew becoming a stockholder or for the purpose of continuing as a stockholder would result in no taxable income to the corporation, but would constitute cost or additional cost of stock to the creditor in the amount of the indebtedness cancelled. Cancellation of debts may also be prompted by motives similar to those which prompt the making of gifts. Under these circumstances, the transaction would constitute a gift subject to gift taxes instead of income taxes.

Not only may the motive and the relationship of debtor and creditor operate to place cancellation of indebtedness beyond the general rule before mentioned but the form or manner of cancellation may have the same effect. In the case of *E. F. Simms*, 28 B.T.A. 988, indebtedness was cancelled in consideration of the transfer by the debtor of property having a lesser cost basis than the amount of debt and the Board held that the transaction was equivalent to a sale of property. In other words a capital gain resulted, which might be taxable in part only, because of the statutory limitations on long-term capital gains, whereas the general rule contemplates that the entire income from cancellation of indebtedness is taxable.

Settlement of a purchase-money mortgage debt for less than its face amount was held by an Iowa District Court in the case of *Hextell* v. *Huston* (28 F. Supp. 521) not to result in income where the amount of indebtedness so forgiven was offset by a shrinkage in the value of the property.

The decision by that court to the effect that shrinkage in the value of the property for which a debt was incurred operated to offset the income from cancellation of indebtedness was not recognized by the Board in its decision in the case of *Kalman Hirsch* (decided in April, 1940) 41 B.T.A. 890. On the contrary the Board held in that case that the value of the property at the time of settlement was immaterial and in its opinion observed that the diminution in value might prove to be of only temporary duration. The Board in deciding that case thus adhered strictly to the rule that a solvent debtor realizes income from cancellation or forgiveness of indebtedness. However, the Hirsch case was appealed to the Circuit Court of Appeals of the Seventh Circuit (115 F (2d) 656), and in reversing the Board the Court held that the settlement operated to reduce the cost of the property, the opinion being premised on the fact that the property at the time of settlement was worth less than the amount of the mortgage thereagainst. The Board in deciding the case of *Killian Company*, 44 B.T.A. 29, has since altered its position to conform with the opinion of the Circuit Court in the Hirsch case. The result is that the Board is now in agreement with several court decisions to the effect that no income is realized from the settlement of purchase-money obligations for less than face amount if the property is worth less than the indebtedness thereagainst, and that such settlements, instead of resulting in income, operate to reduce the cost of the property.

So far I have discussed only the general rule relating to the cancellation of indebtedness reached through a series of decisions. I have also pointed out that the motive prompting the cancellation of indebtedness and the form and circumstances attending the cancellation may operate to mitigate the resultant income taxes and even place the transaction beyond the reach of the income tax.

In addition to the general rule that a solvent debtor realizes taxable income from the cancellation of indebtedness (in whole or in part) in the amount of the indebtedness cancelled or forgiven and its counter rule that an insolvent debtor realizes no taxable income as a result of such transaction, the statutes also contain provisions with respect to cancellation or adjustment of indebtedness. One of these provisions is embodied in the Chandler act and the other became a part of the revenue act of 1939.

Section 268 of the Chandler act contains in the following terms a provision to the effect that no income or profit shall be deemed to have accrued or been realized by a debtor or trustee as a result of adjustment in indebtedness in connection with a proceeding under that act:

"Section 268. Except as provided in section 270 of this act, no income or profit, taxable under any law of the United States or of any state now in force or which may hereafter be enacted, shall, in respect to the adjustment of the indebtedness of a debtor in a proceeding under this chapter, be deemed to have accrued to or to have been realized by a debtor, by a trustee provided for in a plan under this chapter, or by a corporation organized or made use of for effectuating a plan under this chapter by reason of a modification in or cancellation in whole or part of any of the indebtedness of the debtor in a proceeding under this chapter."

That provision has particular reference to reorganizations under section 77B of the Chandler act and would not be difficult of application if it were not for the further provision contained in section 270 of the same act. Section 270, as first enacted, provided that in such instances the basis of the debtors' property (other than money) or the basis of such property (other than money) in the hands of any person required to use the debtor's basis shall be decreased by the amount by which indebtedness has been cancelled or reduced, but not including accrued interest unpaid, cancelled, or reduced, which had not accomplished a reduction in the tax liability. This provision makes it clear that the reduction in the asset base, by reason of cancellation of indebtedness, applies also in cases of statutory reorganizations effected under section 77B of the Chandler act and the reduction to be made in the asset base is not limited to the amount which, under the general rules before discussed, is viewed as income except insofar as such may be inferred from this phrase contained in section 268:

"Except as provided in section 270 of this act no income or profit . . . shall . . . be deemed to have been realized . . . by a debtor. . . ."

The provisions of section 270 have since been amended to the effect that the decrease required in the asset base shall not operate to reduce the basis of the assets below the fair market value at the time of confirmation of the plan. While this amendment has mitigated the effect of the provision as first enacted, it has not cured its possible violation of the general rule by taxing as income in the future amounts in the form of reduced depreciation and depletion, etc., which can not be presently taxed under the established rule. Section 270 as now constituted provides:

"Section 270 (As amended by Public. No. 699, 76th Congress, 3rd Session, approved July 1, 1940). In determining the basis of property for any purposes of any law of the United States or of a state imposing a tax upon income, the basis of the debtor's property (other than money) or of such property (other than money) as is transferred to any person required to use the debtor's basis in whole or in part shall be decreased by an amount equal to the amount by which the indebtedness of the debtor, not including accrued interest unpaid and not resulting in a tax benefit on any income-tax return, has been cancelled or reduced in a proceeding under this chapter, but the basis of any particular property shall not be decreased to an amount less than the fair market value of such property as of the date of entry of the order confirming the plan. Any determination of value in a proceeding under this chapter shall not be deemed a determination of fair market value for the purposes of this section. The Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, shall prescribe such regulations as he may deem necessary in order to reflect such decrease in basis for federal income-tax purposes and otherwise carry into effect the purposes of this section."

In section 19.113(b)(1)-2 of Regulations 103, the Commissioner has prescribed rules for the application of the provisions relating to the reduction in the asset base required to be made by section 270 of the Chandler act. This section prescribes that the amount by which indebtedness incurred to purchase specific property or forming a lien on specific property, is cancelled or reduced, is first to be applied as a deduction from the basis of such property. Thereafter, any further amount by which indebtedness is cancelled or reduced is to be deducted pro-rata from the tax basis of all assets in the following order except that the basis of any asset shall not so be reduced below its fair market value at the date of confirmation of the plan:

(1) Assets other than inventories and receivables
(2) Inventories and receivables

Assuming that the amount of cancellation or reduction in indebtedness has been determined in a given case, the actual computation of the reduction to be made from the basis of the individual assets would not ordinarily present great difficulty. The question of whether or not there has actually been a cancellation or reduction in indebtedness within the contemplation of the provisions of section 270 of the Chandler act may become difficult of determination in many instances. For example, a certain subsidiary in bankruptcy had outstanding common and preferred stock and debenture notes. Practically all of the common stock was held by the parent while the preferred stock and debenture notes were held by the public. The subsidiary's books contained an open book credit of $10,000,000 to the parent company and the parent company's books contained a corresponding debit against the subsidiary. This book account had accumulated over a period of years and consisted of management and engineering charges, cash advances for preferred dividend payments by the subsidiary, and interest charges, etc. Under a plan of reorganization, under section 77B, unsecured creditors were to be paid in full and the preferred stockholders were to receive new preferred and some common stock, while the parent company, as a common stockholder, was not to participate; however, the parent company was to receive some common stock in settlement of its contested claim in the amount of $10,000,000. The consummation of the plan was opposed on the grounds that the parent company was to be given too great consideration and the result was that the plan was ultimately presented to the Supreme Court for decision. The Supreme Court rejected the plan on the grounds that it accorded the parent company too great participation. In rejecting the plan, the Supreme Court severely criticized the parent company for its complete domination of the subsidiary and strongly questioned the validity of the account and very much inferred that if the account had existence in fact, it had through the actions and deeds of the parent company been transmuted to a proprietor's interest, but the Court did not definitely reject the parent company's claim.

Thereafter, a second plan of reorganization was prepared under the terms of which the parent company did not participate either as a stockholder or as a creditor. This plan was finally consummated over the protest of the parent company.

Under such circumstances, I perceive that much litigation may ensue as to whether or not there has actually been a cancellation or reduction in indebtedness within the contemplation of the provisions of section 270 of the Chandler act. In circumstances such as these, thoughts have been expressed that the provisions of section 270 of the Chandler act may be broad enough to require a reduction in the asset base by reason of the disappearance of the open account mentioned. Such thoughts have been expressed on the grounds that the Courts, at no time, definitely rejected the account in question. My own views, expressed from an accounting viewpoint, are that a taxpayer, in such circumstances, would have excellent grounds on which to contest any reduction in its asset base. The facts would remain that, while the parent company received nothing for its claim, other unsecured creditors were paid in full. Such a situation might be viewed as tantamount to rejection of the claim. While the term "cancellation of indebtedness" is not defined in the Chandler act, it is thought that only indebtedness which has existence in fact can be cancelled. Any other meaning might become capricious and lead to absurdities because it would demand reduction in the asset base of the aggregate amount of groundless and exorbitant claims against a bankrupt estate. In other words I suggest the possibility that the reduction in the asset base may be required only where claims allowed by the Courts are settled for lesser amounts because of insufficiency of funds.

With further reference to the provisions of section 270 of the Chandler act, the general counsel in his memorandum No. 22528 has held that, where stock has been received in exchange for bonds or other indebtedness in connection with a reorganization under section 77B, and where the stock received is of a lesser fair market value than the face value of the bonds exchanged, then the difference represents cancellation of indebtedness, which serves to reduce the basis of the debtor's or transferee's assets to the extent provided. This ruling in effect differentiates between a corporation which is voluntarily recapitalized and one which is recapitalized under the provisions of the Chandler act and places the latter at a disadvantage as compared with the former. Many recapitalizations involve an exchange of bonds for stock or an exchange of a certain face amount of bonds for lesser face amount of bonds and stock. Such form of reorganization is ordinarily viewed as a recapitalization under which the corporation retains its former bases of assets irrespective of whether the fair market value of the stock received by the bondholders is less than the face value of the bonds surrendered therefor. Future decisions may clarify the point as to whether this differentiation between corporations passing through an ordinary recapitalization and those recapitalized under the provisions of the Chandler act may constitute discrimination against the latter. It is conceivable also that the creditor who, in connection with recapitalization under the provisions of section 77B, exchanges a debt of a certain face amount for stock of a lesser fair market value may be viewed in the light of a contributor to capital. If a creditor should be so viewed, it would appear doubtful that the disappearance of the debt from the liabilities of the corporation and the substitution of a proprietary interest therefor can be termed cancellation of indebtedness which serves to reduce the asset base.

The other statutory provision to which I have referred is with respect to discharge of indebtedness of corporations in unsound financial condition. That provision was first enacted in the revenue act of 1939 as section 215 and is now embodied in the Internal Revenue Code as 22(b)(9). More specifically, this section provides in effect that there shall be excluded from taxable income of a corporation in unsound financial condition the amount of income attributable to the discharge of indebtedness consisting of bonds, debentures, certificates, or other evidence of indebtedness, if such corporation, at the time of filing its return for the taxable year, files a consent to reduce the basis of its assets (by the amount of such income) for purposes of determining the amount of depreciation and gain or loss, etc., pursuant to regulations to be prescribed by the Commissioner. This privilege of excluding income of the nature stated is limited, however, to corporations and to indebtedness in existence on June 1, 1939, and relates only to taxable years beginning after December 31, 1938, but does not apply to any taxable year beginning after December 31, 1942. Furthermore, it relates only to discharge of indebtedness which took place after the enactment of the revenue act of 1939.

Section 22(b)(9) provides:

"Section 22(b)(9) Income from discharge of indebtedness. In the case of a corporation, the amount of any income of the taxpayer attributable to the discharge, within the taxable year, of any indebtedness of the taxpayer or for which the taxpayer is liable evidenced by a security (as hereinafter in this paragraph defined) if—

(A) it is established to the satisfaction of the Commissioner or

(B) it is certified to the Commissioner by any federal agency authorized to make loans on behalf of the United States to such corporation or by any Federal Agency authorized to exercise regulatory power over such corporation,

that at the time of such discharge the taxpayer was in an unsound financial condition, and if the taxpayer makes and files at the time of filing the return, in such manner as the Commissioner with the approval of the Secretary, by regulations prescribes, its consent to the regulations prescribed under section 113(b)(3) then in effect. In such case the amount of any income of the taxpayer attributable to any unamortized premium (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be included in gross income and the amount of the deduction attributable to any unamortized discount (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be allowed as a deduction. As used in this paragraph the term "security" means any bond, debenture, note, or certificate, or other evidence of indebtedness, issued by any corporation, in existence on June 1, 1939. This paragraph shall not apply to any discharge occurring before the date of the enactment of the revenue act of 1939, or in a taxable year beginning after December 31, 1942."

To gain the privilege of the foregoing provision, a corporation must establish to the satisfaction of the Commissioner that it is in unsound financial condition. Certification to the Commissioner that the corporation is in unsound financial condition by a federal agency authorized to make loans or by a federal agency authorized to exercise regulatory power is conclusive proof thereof. Absence of proof to that effect or failure to file the necessary consent renders the corporation presently taxable on income from discharge of indebtedness and deprives it of the right of spreading such income over future years by reducing the basis of its assets.

If the corporation so elects by filing the required consent, the amount of income attributable to the discharge of indebtedness is to be applied as a deduction from the basis of the assets in a manner and sequence similar to the deduction required by section 270 of the Chandler act.

While there is much similarity in the provisions of section 270 of the Chandler act and the provisions of section 22(b)(9) of the Internal Revenue Code, their effect upon income taxes differs, however, in two material respects:

(1) Section 22(b)(9) of the Internal Revenue Code grants the taxpayer the election of either reducing the asset base or presently reporting for tax purposes the amount of income attributable to the discharge of indebtedness, while reduction in asset base is mandatory under the provisions of section 270 of the Chandler act.

(2) If deduction in asset base is elected under the provisions of section 22(b)(9) of the Code, such deduction is limited to the amount which constitutes income, whereas the limitation of the similar deduction under section 270 of the Chandler act is that the assets shall not be reduced below their fair market value.

In concluding my remarks upon the subject of "cancellation of indebtedness and its effect upon income taxes," I wish to elaborate briefly on the observation previously made with respect to the amendment in 1940 to section 270 of the Chandler act. This amendment was to the effect that the deduction required in the asset base by reason of cancellation of indebtedness shall not reduce the basis of the assets below their fair market value at the date of confirmation of the plan. With respect to that amendment, I made the observation that it had mitigated but not cured the possible violation of the general rule that income is realized from cancellation of indebtedness only to the extent of the assets freed or the solvency created thereby. To illustrate the thought in mind, let us assume that a corporation in bankruptcy has assets with a tax basis of $1,000,000, bonded indebtedness of $1,000,000, and unsecured creditors of $100,000. That under a plan of reorganization under section 77B, there will be issued to the bondholders new bonds of the face amount of $500,000 and common stock at the stated or par value of $200,000 against the assets then of the fair market value of $700,000 and that the unsecured indebtedness is cancelled. Under these circumstances and under the provisions of the Chandler act, as interpreted in the general counsel's memorandum No. 22528, there has been a cancellation of the indebtedness in the amount of $400,000, namely, $100,000 unsecured debts and $300,000 as relates to bondholders (assuming the stock issued, $200,000, represents its fair market value). The deduction in the asset base, however, is limited to the amount of $300,000, the amount necessary to reduce their present basis, $1,000,000, to their fair market value, $700,000.

If this corporation had been discharged of indebtedness in the same amounts, but without reorganization under section 77B then the maximum amount, which, under the general rule before discussed, could constitute income, would appear to be $200,000, the amount of assets freed or the amount of solvency created. Such maximum income is the amount which the corporation may elect, under the provisions of section 22(b)(9) of the Code to report immediately or deduct from the basis of its assets.

Thus, in the example given, section 270 of the Chandler act mandatorily requires a deduction in the asset base of $300,000, whereas the similar deduction, without reorganization under section 77B is only $200,000. This situation may suggest to those with more of a legal turn of mind than I the possibility that the provisions contained in section 22(b)(9) of the Code may more truly reflect the point beyond which the provisions of section 270 of the Chandler act may not constitutionally be applied.

Tax Problems of Pension and Profit-Sharing Plans

BY GEORGE F. BREWER, CHICAGO, ILL.
Member, American Institute of Accountants

THIS paper deals with pension and profit-sharing plans established for the benefit of employees and so constructed that the employer may deduct its contribution to the plan in the year in which made or accrued and that the beneficiary is not required to report as taxable income benefits from the plan until the years in which they are received by him.

The employer may be an individual, a partnership, or a corporation, but proprietors or partners cannot personally be included among the beneficiaries. For sake of convenience, the employer will hereafter be referred to as a corporation. In recent litigation the Commissioner took the position that officers were not employees, but the Board ruled that "there is no merit in the respondent's (Commissioner) contention that officers may not be employees."

If a corporation may deduct for income and excess-profits-tax purposes amounts set aside for retirement and profit-sharing programs in the years in which such payments accrue, and if the beneficiaries of such plans are not required to report as taxable income the amounts set aside by the corporation until some years after the date of the corporate contribution, substantial total tax savings may result.

Pension and profit-sharing benefits under the more common plans are presumably set aside for the employee beneficiaries during the years when such beneficiaries are active with the corporation. In those years their normal income from salaries and wages (and perhaps other sources) is almost always larger than in years after they have reached a retirement age.

Present high corporate taxes and the expectation of their continuance lend an added interest in this subject. Let us say that John Jones, the employee, is forty and expects to retire at sixty-five. His employing corporation might wait until he has reached sixty-five before providing for a pension, and in such case the pension would be deductible only when paid. There are some who are optimistic enough to believe that corporate tax rates will be lower twenty-five years from now than they will be in the next few years. If this results, it is much cheaper for the corporation, tax-wise, to set aside annual amounts for John Jones now when taxes may run as high as 60 or 70 per cent than to pay out the same amounts in some future years when corporate rates may again be back to a low level.

So with some prospect of lower future rates (both individual and corporate) and the probability of the beneficiary's income being in much lower tax-rate brackets at sixty-five than at forty—a pension or profit-sharing plan which will accomplish the desired end appears to be one of the best over-all tax bargains available today.

While employees' trusts have been specifically provided for in revenue acts since 1921, there has been an amazing lack of litigation on the subject. In the last two years there have been only five Board of Tax Appeals decisions and no court decisions dealing directly with the important tax questions in employees' pension and profit-sharing plans. Most of the administrative tax authority is based upon a few published rulings of the internal-revenue unit.

It might be assumed, in view of the absence of Board or court decisions—and what few there are have not been conflicting—that this is one field of taxation which is fairly well settled. Such an assumption may prove erroneous. There may be today in the making a series of potential cases which will make the law on this subject quite different ten years hence than it now appears. There are many reasons for believing that substantial potential pitfalls exist in the tax aspects of pension and profit-sharing plans.

Let us first consider those plans which seek to qualify under section 165 of the Internal Revenue Code. If the plan complies with the provisions of section 165, then under section 23(p) of the Code the corporation is specifically allowed a deduction from gross income for its contribution, not only to the extent of the pension contribution accruing during the taxable year but also for one-tenth in each of ten years of some amount paid in excess of the current accrual.

To qualify as a section-165 trust the statute provides that:

1. The plan must be for the exclusive benefit of some or all of the employees.
2. The earnings of the trust must go to the employees.
3. No part of the trust may be diverted to other purposes until all liabilities to employees are satisfied.

The section provides that the income of a qualified trust shall not be taxed to the trust and that distributions of the trust shall be taxed to the beneficiaries only in the amount "actually distributed or made available" and "to the extent it exceeds the amounts paid in" by the beneficiary.

What, then, are the problems in qualifying a trust under section 165?

The first of these questions relates to the selection of persons eligible to participate in the trust. A 1940 ruling of the Bureau (I.T. 3346) held that 50 selected employee beneficiaries out of some 25,000 employees was too small a number to qualify the trust under section 165. On the other hand, the Board of

Tax Appeals has decided that a restricted number of beneficiaries—seven officers—did not disqualify a trust, stating, "If the trust is created for the exclusive benefit of *some of the employees* the requirements of the statute are satisfied." (Albert W. Harris, et al., B.T.A. Memorandum Opinion.) But there has been no real litigation on the point, and the Commissioner is not satisfied with this Board opinion. The Commissioner's attitude at the moment seems to be that if beneficiaries of the trust are determined by some general principle, such as all persons above a certain salary scale, or by a definite number of years of employment, then the trust will qualify; but if the beneficiaries are hand-picked, then the trust will be challenged. Some seem to feel that if the trust is to be confined to the executive group it should be open to all persons earning $3,000 or more a year, who may also be required to meet some standard length-of-employment qualifications. The $3,000 level is picked because federal social-security benefits do not increase for salaried persons above that level.

A contributory plan, under which the employee pays part of the cost of the pension program, is believed to be generally safer than a noncontributory plan. The option to come in or stay out is a factor of strength since it opens the trust to all who desire to participate.

Certain it is that a trust whose beneficiaries are limited to a few persons—all important stockholders—is in grave danger of being challenged, even though it meets all the other technical requirements. (*W. F. Parker* v. *Commissioner*, 38 B.T.A. 989.) Between this extreme and the inclusive pension program for all employees is a wide range of plans. And taxwise, it is very uncertain where the lines of demarcation may ultimately be drawn.

The corporation's contributions to the trust must of course be almost irrevocable. While reverter provisions will not necessarily damage the trust taxwise, reversion to the corporation or diversion to other purposes must be only after all obligations to the trust's beneficiaries are satisfied. The Bureau has held that where the corporation retained valuable rights in the trust property, the trust could not qualify under section 165. There is a complete void of decisions on this point.

It should be noted that, if a pension plan is qualified under section 165, the corporation may deduct *in full* in the year of payment only the pension contribution accruing for that particular year. If additional sums are put into the trust, either to pick up the pension accrual for past years or to fund pension payments for future years, such lump-sum payments must be spread over the year of payment and nine subsequent years—or one-tenth in each of ten years. This is probably true even if the lump-sum payments were made in sections, for example, one-third in each of three years; each lump sum would be amortized as a tax deduction over ten years.

Many corporations have adopted pension plans set up by means of retirement income or annuity contracts with an insurance company, rather than operated by trustees. In fact, insurance-company pension programs are more in use today than are independent trusts since the investment record of the latter during the depression years was generally none too good. Some of such underwritten plans have gone through the motions of having trustees through whose hands the contributions pass. Others have completely omitted the trust machinery, the employer corporation paying directly to the insurance company both the corporation's and the employees' contributions. The latter method would not seem to meet the requirements of section 165, which speaks in no uncertain terms of "a trust." Yet the attorneys for many corporations and insurance companies feel that such a direct company-to-insuror relationship does qualify under section 165. To date, at least, the Bureau has approved insurance-company programs, probably on the grounds that the statutory word "trust" does not require a formal type of trust. The Bureau has, and the writer believes rightly, taken the position that annuity contracts which provide benefits starting at some future date are the equivalent of pension trusts even though the annuity benefits are not specifically disbursed as pensions. While these interpretations seem quite reasonable and within the intent of section 165, it should be noted that they have not been adjudicated.

Let us examine, from the corporate standpoint, the status of pension and profit-sharing plans that do not fall within the technical requirements of section 165. Under the broad authority of section 23(a), payments to employees as pensions and profit-sharing are deductible as ordinary and necessary business expenses, subject only to the limitation that the amounts paid when added to the employees' other compensation do not exceed a reasonable compensation. Under section 23(a) there is no requirement for spreading over a ten-year period the lump-sum amounts which may be paid out to catch up with past pension accruals. In this case the total sum paid or set aside is deductible only in the year paid and subject to the limitation of reasonableness not present in such lump-sum payments under a section 165 trust. (I. T. 2910.)

There are many situations where it may be to the advantage of the corporation to keep its pension program outside of the limitations of section 165 and the related section 23(p). If a trust is created which does not meet section 165 requirements, then the trust itself will presumably have its income taxed under section 161, but if the trust funds are invested in annuity contracts it would appear that under present Bureau rulings the corporation's contribution to the trust is not taxable income to the trust.

If the deduction is sought under section 23(a), the number of persons involved seems at present to have no bearing on deductibility. The Bureau has ruled that payments to a trust for the benefit of *one* person, the corporation's president, were deductible in the year made. (I.T. 3346.)

Most of the contingent problems of pension and profit-sharing plans relate not to the deduction by the corporation but to the incidence of taxation to the individual beneficiaries.

Under a section165 trust, the statute provides exclusion from taxable income of the employee of the amounts contributed for his benefit in the year contributed by the employer, and for the inclusion in taxable income of amounts "actually distributed or made available to any distributee" in the year in which so distributed or made available. What constitutes actual or constructive availability of benefits is a wide field for differences of opinion.

It has been held that blocks of stock set aside in each of five years in trust for corporate officers (with dividends to go to them at the end of the period, absolute rights vesting in their heirs in event of death prior to termination, and forfeiture only in the event the officers leave company employ during the five years) become taxable to the officers in the year in which the stock and dividends were released to them. (*Fred S. Olson* v. *Commissioner*, 67 F. (2d) 726.)

Where the terms of the trust permitted the employee at his option to withdraw from a profit-sharing fund at the end of ten years or any time thereafter and he elected not to withdraw until some years after the ten-year period, it has been held that the amount distributed to him was taxable, not at the end of the tenth year but in the year of actual withdrawal and actual receipt of the funds. This 1940 decision of the Board (*Dillis C. Knapp* v. *Commis-*

sioner, 41 B.T.A. 23) carried a dissenting opinion of three members who believed the benefits to be taxable to the employee at the end of the tenth year on the grounds of availability. From that moment on, the funds were subject to the employee's demand. (See also *Asher* v. *Welch*, Dist. Ct., Calif., S.D., May 24, 1938.)

It has been held, in the case of a trust for the benefit of a few corporate officers, the trustees being other officers of the corporation and having broad discretionary powers as to the years and amounts of distributions, that the amounts paid were not taxable income to the beneficiaries until distributed. (*Harris, et al.*, v. *Commissioner*, Memo Opinion, Oct. 27, 1939, Docket Nos. 92482–486, incl.)

The Bureau has ruled that if an annuity contract is purchased either for one or for several employees and is then or at a later date delivered to such employees with no strings attached, the annuity payments are taxable to the employee when and as received in cash. Even when the annuity contract has a cash-surrender value available immediately to the employee, the cash-surrender value is not taxable to the employee until he actually exercises his right and receives the cash. (I.T. 3346, I.T. 2891.)

It is interesting to speculate what the Bureau's attitude would be if a United States Savings Bond were purchased for an employee and immediately given him free and unrestricted. It has an available cash value, but so have most annuity policies. Would the bond be taxable to the employee in the year he received it or in the year he cashed it?

It seems clear that existing authority is very liberal in postponing the incidence of taxation to the beneficiary. In view of the general trend of tax decisions, will this always be the case? Certainly, a very strong case could be made for taxing the beneficiary on the basis of constructive receipt if cash surrender values are freely available to him at his option.

In order to avoid the potential danger of having pension benefits ruled to have been constructively received by the beneficiary, consideration should be given to the possible pitfalls. First of all, and basically, the plan should be a bona fide benefit plan, not just a subterfuge for postponement of taxable income. The following may affect this aspect of the plan:

1. *Selection of the group.* The larger the number of eligible participants, the safer the plan. Selection by general rules seems better than arbitrary designation of a few individuals.
2. *Selection of trustees.* If all the trustees are also the major beneficiaries of the plan and the trustees are given broad discretionary powers, then the plan may be challenged. The more removed the trustees are from the plan's benefits, the safer it will be.
3. *Powers of trustees.* Too great discretion in the trustees as to selection of years and amounts to be distributed may give the plan a bad appearance, particularly if the trustees are in substance controlled by or subject to strong influence from beneficiaries.
4. *Rights of beneficiaries.* If the beneficiaries are given too many rights under which they may elect benefits, then potential "availability" comes dangerously close to actual. The safest course would appear to be the retention by independent trustees of substantial powers, leaving the beneficiary only the right to receive certain amounts in specified years.
5. *Uniformity of provisions.* The plan should work on an equal basis (or nearly so) for all beneficiaries. Jones' retirement benefits should not start at fifty if Smith's start at sixty-five. The plan should operate along general rules applicable to all.

A few collateral points of interest may be touched on.

Many insurance annuity policies such as the life-income policy carry death benefits in the earlier years of such policies, in excess of the cash-surrender value of the annuity. These excess death benefits disappear in the later years, and if the beneficiary lives to normal retirement age, there is at that time no insurance as such. In effect, premiums have been paid for term insurance. The Bureau has ruled (I.T. 3268) that to the extent the payments to the insurance company pay for life insurance, the amount of the payment applicable to the insurance feature (if paid by the employer) is taxable income to the employee in the year the premium is paid. Yet the premiums and the insurance are never available to the employee. The insurance benefit goes to his heirs only if he dies. Why should the cost of contingent death benefits be taxed to the employee when the cost of a cash-surrender value of an annuity is not? Arguments can be advanced on both sides. The courts have decided that life-insurance premiums paid by an employer, where the proceeds would inure to the benefit of his heirs or his designated beneficiaries, are taxable as income to the employee in the year paid. (*Yuengling* v. *Commissioner*, 69 F. (2d) 971.) They have not ruled on this question when the insurance is an incidental feature to a pension plan. It is expected that this question may be presented before the Board of Tax Appeals in the near future.

Most pension and profit-sharing plans provide for a fixing of rights upon the death of the employee, either before or after retirement age. This involves an estate-tax question. If death benefits are payable outright, then the value of such benefits at date of death would seem clearly to be includible in the taxable estate of decedent—less, however, the total sum contributed by the employee to the fund. If the benefits consist of a continuing annuity to his beneficiaries, the taxable amount would seem to be the commuted value of such annuity at the date of death.

A final problem of interest arises where, by reason of an early death, in addition to the commuted annuity benefits, a lump-sum insurance benefit accrues. Let us assume that trustees have applied for the insurance, paid the premiums, and retained all the incidents of ownership. Are the insurance benefits taxable for estate-tax purposes? The Bureau has stated informally that under such circumstances they would assess an estate tax against the insurance proceeds. Yet the decedent never applied for the insurance, never paid any premiums, never held incidents of ownership—and, by ordinary rules, insurance proceeds paid under these circumstances would pass free from estate tax. Some day this question also may come up for decision.

In closing, it may be emphasized that most of the law on this subject is yet to be made. Because pension plans have only recently come into general popularity it may be many years before the existing uncertainties are resolved by litigation and legislation. A good policy in these matters therefore would seem to be—proceed, but with caution, and where possible procure specific rulings of the Bureau upon the plan involved.

III

Research and Terminology

RESEARCH

Chairman: WALTER A. STAUB *September 17, 1941*

Introduction

BY WALTER A. STAUB, NEW YORK

Member, committee on accounting procedure,
American Institute of Accountants

BEFORE we go to the formal papers of the afternoon's session I should like to call on the chairman of the committee on accounting procedure so that he may speak to you briefly.

I think we have been exceedingly fortunate during the three years that have elapsed since the research department of the Institute was organized and the committee on accounting procedure has had the responsibility for directing that work and utilizing it for the work of the committee and the formulation and the promulgation of the bulletins that have been issued, that we have had as chairman of the committee, or as its active head, George O. May.

Those of us who have had the pleasure of knowing him through the years have learned to value very highly his leadership in the profession. The contributions he has made are beyond evaluation because they have been so important. Through his work in connection with this committee, he has given a trend and a direction to our research activity that will stand us in good stead through the years that follow.

Mr. May will speak to us briefly on the work which we have sought to accomplish in the field of research, and if he does not find time to deal with it in all of its details, may I say that I feel that he has given us something of great value in giving direction to the development of our aims in the research work, our approach to the problems that we have before us in that work, and even the technique of the consideration of these problems and the form of presentation of the results that are reached.

I take great pleasure in calling upon Mr. May to speak to us at this time.

Comments of George O. May

As you perhaps know, Dr. Sanders, who was the head of the active research work, took a government position to try to help out in Washington this summer, so that with this meeting both his duties and my duties come to an end and the committee will be making a new start.

This is a very good time, therefore, to appraise the work that has been done and to decide whether any new direction should be given to the efforts of the committee. For that reason I have acceded to Mr. Staub's request that I say just a few words about our general objectives and what we have tried to do during the three years since this department was organized.

You might say that our work really grew out of the expression "generally accepted accounting principles" as used in the standard form of certificate. That involved immediately questions of what we meant by accounting, what we meant by principles, as well as more detailed questions.

It was early recognized that terminology was a very important element of the problem, and so in the second year of our work it was arranged that the committee on terminology should be practically a subcommittee of the committee on accounting procedure. Since that time the bulletins of the committee on terminology have been submitted to the committee on accounting procedure for approval.

That has been a very important point, because there has been a great deal of difference of opinion as to just what was meant by accounting principles and what was meant by a lot of the terms that were commonly used in accounting.

If I remember correctly, Mr. Werntz in his address yesterday spoke of accounting having been heavily pragmatic until recently. Now, the word "pragmatic," like so many other words, has very many meanings to different people, and it has a rather unfavorable sense most often. I think he had that unfavorable sense in mind when he spoke of accounting having been heavily pragmatic, but I feel very distinctly that unless accounting is pragmatic in the sense of being practical and giving results that are satisfactory from the standpoint of practical results, it will cease to perform the function which it should perform.

If you read our first bulletin you will see that we took that position very clearly. We said that the corporation was a part of the social system, that corporation accounting was a part of the corporate system, and the results that both produce must be judged from the benefits or ill effects on society at large. That is the viewpoint from which we have tried to approach this question.

We also realized that accounting is directed to a purpose, and several pronouncements that have come from the Securities and Exchange Commission have emphasized that point of view.

You cannot understand what are sound accounting principles without having a clear idea of the purposes of accounting. As you all know and as we emphasized in our bulletin, there has been a great shift in what is conceived to be the major purpose of accounting, and it is being considered more from the standpoint of the people who buy and sell securities and less from the standpoint of the continuing owners.

I should like to emphasize that for a moment, because I am fearful that that tendency may be carried too far. After all, the corporations whose securities are traded in are very small in number, although they are important. I should like to see some way developed of getting more complete representation of the views of people who are interested in small corporations, who are not concerned with the market value of their stock, and to whom the old ideas of conservatism appeal more than they do to people who are concerned with stocks from a speculative view.

One thought that I should like to leave behind, in giving up my position, is that I hope more can be done to get expression of the point of view of the people who are not interested in listed securities. Of course, some people say that our work does not interest them because they are not interested in listed securities and it is only important to people who do business with the Securities and Exchange Commission. Obviously the rules laid down by the S.E.C. are only binding on the people who report to it. They are bound to influence the judgment of the courts in other cases that come before them. I do think that those members whose interests are in companies whose securities are not listed ought to make themselves vocal and get adequate representation of their views and not allow the whole trend of accounting to be dictated by considerations relating to companies that come under the jurisdiction of the S.E.C. and other regulatory bodies.

That is the main thought that I want to put before you today.

I should like to draw your attention to our last bulletin on stock dividends, because we there take a step beyond those we have taken before. In our earlier bulletins we tried to discuss what accounting was, what the objectives of accounting were, and what we meant when we talked about an accounting principle. We laid emphasis on the fact that it was not a fundamental principle like a natural principle but only a postulate that had proved itself so valuable that it became a principle, and we tried to deal with specific cases. Those were the branches of our work.

Now, in the bulletin on stock dividends we undertook to go one step further and discuss some things that were not questions of accounting principles but what we called questions of good corporate policy in the field of accounting.

We had quite some discussion in the committee as to whether we should go into that field, but we decided to go into it because we felt that the Institute ought to exercise an influence in regard to business practices in the general field of accounting even if they are not purely accounting questions.

We realized that stock dividends gave rise to implications which were misleading and we tried to outline methods which we recommended. We cannot enforce them, but we recommended corporate managements to consider these questions when declaring stock dividends because if they did so, they would be promoting what you might call sound corporate morality.

Now, I think that this was a wise step, and I hope the committee will continue to take a lead in the position of encouraging sound corporate morality in the fields with which it is concerned, because, as someone said yesterday, we are all a part of this system of free enterprise and unless this system of free enterprise conducts itself in a way that commends it to the popular sentiments in general and is regarded in society as a desirable thing, it is going to be discarded. We have a selfish interest as well as an interest that I think is founded in much deeper considerations in promoting a healthy financial policy in the field of accounting, as well as sound accounting principles.

I don't know whether any of you have seen the report of the committee on terminology, but if not, you may have seen reference to the fact in the press that we have recommended that this committee consider the possibility of eliminating the word "surplus" from the balance-sheet because it creates an impression of value in so many minds, and accounting statements are not statements of value except in so far as assets expected to be realized in the near future are concerned.

Now I might say that that is an idea which has been in my mind for a great many years, but I never thought that it would be so well received. However, it just shows how much education has been accomplished in the last three years. When our committee prepared that report we submitted it to the full committee on accounting procedure with the expectation that we would get some violent reactions to it. But they all said, "What an excellent idea!" No one offered any objection.

Then I submitted it to the council on Monday, and the council only inquired as to what they could do to help.

Now, that shows that we are stirring and that we have some life and thought and we are not afraid to break with the past and discard ideas, no matter how long they may have been entrenched, if we think that by so doing we are going to add to the value of the profession and the enlightenment of the community.

That is all I wanted to say today except to take this opportunity of expressing my thanks to all the members of the committee for the wonderful support that they have given me and to express my confidence that they will give a similar support to my successor who, I am sure, will carry on the work with even greater success than he has been kind enough to attribute to me.

The Use of Accounting Data by Economists

BY JAMES L. DOHR, NEW YORK

Chairman, committee on publication; member, committee on accounting procedure; American Institute of Accountants

IN AN age of specialization there is obviously an urgent need for the coordination of specialists. Accountants have recognized this need, and in their efforts to be of maximum usefulness in the business world, they have given extensive consideration to related procedures in the fields of law, engineering, taxation, mathematics, etc. Practitioners in other fields have likewise given thought and study to the procedures of accounting. The interrelationships of accounting and economics have had less attention than they deserve due, perhaps, to the fact that accounting is in its very essence practical, whereas much in the science of economics, despite its long history, is scarcely within the realm of practice or workability. In addition, economists in times past have on the whole failed to realize and appreciate the significance of accounting and have neglected it in their studies.[1] There are exceptions, of course, as for instance the work of John B. Canning entitled "Economics of Accounting," which indicates a full appreciation and a keen understanding, on the part of an economist, of the accounting science. Obviously, accounting data is of the utmost importance in economic philosophy, and it is distinctly encouraging, therefore, that the American Institute of Accountants should see fit to consider the relationships of accounting and economics on this program. The purpose of this paper is to indicate briefly the possible uses which may be made of accounting data in economics, to point out the accountant's responsibilities in the development of adequate data for such uses, and to consider the propriety of current uses of such data by economists.

THE USES OF ACCOUNTING DATA

In its broadest aspects the science of economics is very largely concerned with the regulation and control of business activities in the social organism—regulation and control effected largely through the medium of government. We are all familiar with the various uses which have heretofore been made of accounting data in connection with the regulation of the business enterprise and the conduct of business. In such matters as income taxation, the regulation of public-utility rates and charges, the control of selling prices, the liquidation and adjustment of the business enterprise and in other situations, accounting data has been of paramount importance.

It is apparent, however, that there are broader and more vital purposes for which accounting data may be used.

[1] Fisher, "Review of the Economics of Accountancy," XX *American Economic Review* No. 4 (Dec. 1930), p. 618. In calling attention to the economist's failure to appreciate the value of accounting data, the author points out that accounts represent primarily those measures of business which are "practical" and "workable."

The central problem of our economic system is the production and distribution of wealth. We are vitally interested with the amount and utilization of our national income. We are particularly concerned with the level of economic activity since our well-being seems to depend very largely upon the maintenance of satisfactory levels. Economic activity involves many factors, including such matters as savings, the investment and reinvestment of capital, rates of turnover, wages and unemployment, taxation, technological development, etc. If we concede the necessity of governmental regulation in any of these connections, we should insist that the regulation be based upon reliable data; that data is largely accounting.

The Responsibility of the Accountant

A question is immediately raised as to the responsibilities of the accountant in this situation. As a matter of history, it seems obvious that accounting evolved largely as an instrument of internal business control. The accountant was employed by the owner or manager of the business enterprise, and his techniques were developed to provide his employer or client with data which could be used in the administration of the enterprise. Because of this fact, it has been suggested that accounting, as it is practiced, is essentially "individualistic" or "private" in that the accounting objective is primarily a matter of service to the so-called selfish objectives of the employer or client. It has been intimated further that the attention of the accountant has been directed to his "social" or "public" responsibilities only within the last decade, and there largely as a result of external persuasion.

It is submitted that this is not a proper view. Public accountants have long recognized their social or public responsibilities; in their efforts to develop accounting on a professional basis and in setting for themselves high standards of professional conduct, they have envisaged the accountant as an unbiased and unprejudiced investigator of fact, a seeker for the truth, and a public spirited citizen. If the social aspects of accounting have not been adequately recognized in times past, the fault, in a measure at least, lies in the fact that the accountant did not occupy a sufficiently independent position. It may be agreed, of course, that the last decade has witnessed a marked increase in emphasis on his social responsibilities, but, to greater or lesser extent, the same is true of many activities.[2] In any event, there is no doubt but what accountants can and will produce such information as may be necessary for the broadest of social objectives.

The Adequacy of Accounting Data

The question as to the adequacy of current accounting data for these broad purposes must be divided into two parts. The first part involves the adequacy of the basic data as prepared and reported by various business enterprises. The second part of the question relates to its availability for the desired purposes. With respect to the latter, it is painfully obvious that assembly and compilation of accounting data are woefully inadequate. The only comprehensive summary of accounting data is that of the Bureau of Internal Revenue in its compilation of statistics based upon the income-tax returns. Anyone who has used this data has a full realization of its limitations. Beyond this we have only the spasmodic or limited studies made by various governmental and private or quasi-private organizations. Until some procedure is developed for the assembly, compilation, and pres-

---

[2] For an interesting discussion of the responsibility of business, its "social performance" and an attempt to measure such performance, see Temporary National Economic Committee, Monograph No. 7, "Measurement of the Social Performance of Business." While the objectives of the study are praiseworthy the conclusions drawn border on the fantastic.

entation of accounting data, it is not possible to determine fully whether the basic facts have been adequately or properly reported. Accountants may well urge that machinery be provided for the comprehensive collection and tabulation of accounting data.

As to the adequacy of the basic data, the final verdict must await complete tabulation. Some things are, however, already apparent. There is obviously a need for greater uniformity. In the income statement, for instance, something may have to be done about the great variety of so-called debits and credits to surplus. Duplications, as in the case of financial losses of one concern and the bad-debt loss of its creditors, may have to be eliminated. In the balance-sheets, provision may have to be made for the elimination of intercompany accounts and other items in the manner of the consolidated statement. Numerous other amplifications or modifications may have to be developed. Basically, however, it appears reasonably certain that the data as currently reported is satisfactory and that no fundamental changes in accounting procedures appear to be necessary.

The Use of Accounting Data by Economists

The current monographs of the Temporary National Economic Committee present an opportunity for the observation of the use, by economists, of accounting data since these studies involve extensive utilization of such data in a wide variety of situations. In a paper of this kind it is obviously impossible to consider these monographs in their entirety since they include over forty highly detailed and elaborate studies; attention is therefore directed to those which are of peculiar interest to accountants, i.e., Monographs Nos. 7, 12, 15, and 37, dealing respectively with "Measurement of the Social Performance of Business"; "Profits, Productive Activities and New Investment"; "Financial Characteristics of American Manufacturing Corporations"; and "Savings, Investment and National Income." It will be observed that these studies deal largely with the so-called corporate system and particularly with its relationship to national income, the distribution, saving, and reinvestment of such income, and the problem of "idle men and idle money." The various uses of accounting data by the economists in the designated monographs may be considered in terms of the following phases of the studies:

(1) The volume of corporate income (Monographs 12 and 15)
(2) The rate of corporate income (Monograph 12)
(3) The margin of corporate income (Monograph 12)
(4) The distribution of corporate income (Monograph 12)
(5) The savings from corporate income (Monographs 12 and 37)
(6) The reinvestment of corporate-income savings (Monograph 12)

To clarify what follows, it should be pointed out that these studies are set forth as indicating that the concentration of corporate stock ownership and the savings of corporate income, either within the corporation or from dividends, are such that the corporate system does not absorb such savings and that its stockholders do not and can not consume the additional products which are or would be made possible by the reinvestment of such savings. The concentration and savings are therefore by implication at least deemed objectionable.[3] While attention is directed here only to the use of accounting data in the studies it may be noted in passing that this general thesis is far from established.

---

[3] In order that no one fail to appreciate this implication, every page of every study, whatever its subject matter, is entitled "Concentration of economic power."

The Volume of Corporate Income

The only figures available on the aggregate corporate income in the United States are the tabulations of the Bureau of Internal Revenue based on income-tax returns which are concededly not satisfactory for the purposes at hand. These figures indicate an average annual income for all corporations from 1909 to 1937 of about three and one-half billion dollars.

The study of this data in Monograph 12 leads the author to certain conclusions as to the determination of corporate income among which are the following:

(a) The "ideal" method of income measurement for an accounting period is a comparison of "values" at the beginning and end of the period with appropriate adjustment for equity capital received and dividends disbursed.

(b) The "ideal" method is not satisfactory to or used by business because business is interested primarily in "operating profit" and not in changes in "capital values."

(c) Income is not an exact amount and can not be precisely measured; it can be determined only within fairly wide limits; available financial statements do not show that reported income is within proper limits.

(d) The average annual corporate income of three and one-half billion dollars as shown by the tax returns is probably understated by a billion dollars because:

1. Losses are duplicated;
2. Tax returns understate profits;
3. A reconciliation of "net worth," as shown by the income-tax balance-sheets indicates an unexplained increase, from 1909 to 1937, which is the equivalent of an average annual accumulation of income of not less than one billion dollars;[4]
4. Accountants are ultra conservative in their income computations.

The proposition that the income of a period may be measured by a comparison of "values" at the beginning and end of that period is an attractive but nevertheless basic fallacy. It is akin to the notion that "net worth" is indicated by the balance-sheet and that income may therefore be determined by a comparison of balance-sheets. The truth of the matter is that "worth" is not as a general rule so determinable; the balance-sheet position in fact depends very largely upon what is done in the income statement. What is more important, "values" are determined by income rather than vice versa. The accountant and the businessman are therefore on sound ground when they reject the so-called "ideal" method of income determination.

One may readily agree with the proposition that income is not an exact amount and that its determination requires the exercise of judgment within fairly wide limits of propriety. As to the charge that available financial statements do not indicate whether reported income is within such limits, the evidence is far from conclusive. Apparently the author bases the charge upon the alleged fact that income statements are not so arranged as to show profit computations in the three categories of (1) determinate money values based upon exchanges between independent bargaining agents; (2) interim approximations of portions of money values determinate only in the long run, such as those for depreciable and depletable property, and (3) arbitrary money values set in transactions between non-independent bargaining agents, such as those between a corporation and its controlling stockholder, or in transactions which do not involve cash. There is, of course, merit in this suggestion; as a matter of fact, however, accountants have long since recommended the sepa-

[4] The increase in "net worth" over the 29-year period appears at $94,000,000,000; profits were $102,000,000,000; dividends were $93,-000,000,000; retained profits were therefore $9,000,000,000. Allowance for known additional stock issues (net) of some $28,000,000,000 leaves an increase of over $66,000,000,000 to be accounted for.

rate showing of such items as depreciation and depletion, and they appreciate fully the distinction between values determined by independent bargaining agents and values not so determined. It does not follow that the mere showing of these items in the income statements will make it possible for the reader to determine whether the reported income is within proper limits. This can be done only by the application of accounting principles in the preparation of financial statements and by the certificates of auditors that the computation is in accord with such principles.

The evidence does not support the charge that corporate income as shown by the income-tax statistics is understated. The unexplained increase in net worth may be due to a variety of causes, and would, of course, be explained if the basic data were adequately tabulated. As a matter of fact, the data on additional stock issues is concededly incomplete. And while the unexplained increase in net worth is interpreted here as being due to understated income, it is, later in the same monograph, interpreted as being due in part, at least, to upward revaluations. In addition, it may well be doubted whether the tax returns, in the final analysis, understate corporate profits. In many cases, taxable income is higher than any reasonably computed income. Finally, it is by no means helpful to describe accountants as being "conservative." The truth of the matter is that accountants are, and should be, realistic in their income computations. When they depart from realism, they will have committed suicide.

The Rate of Corporate Income

Corporate income over the period surveyed fluctuated generally within a range of five to seven per cent of contemporaneous book values as shown by the tax-return balance-sheets. The author of Monograph No. 12 concludes that the indicated percentages of returns are not significant. His reasoning in this respect may be summarized as follows:

(a) Net worth as shown by the books bears very little, if any, consistent relation to cost, i.e., no consistent relation to what was actually received from investors (including retained profits), and in many cases reflects values established by nonindependent bargaining agents. Book net worth is largely what a corporation finds it necessary, convenient, or desirable to have.

(b) Book values in general and in the long run are adjusted to earning power.

(c) There have been substantial upward revaluations in net worth amounting to as much as $5,000,000,000 in a single year. The cumulative effect of these revaluations is such that there is little significance to the rates of return.

It may readily be conceded that the ratio of earnings to book values is not significant except as a matter of enterprise accounting. In this respect, however, accountants are fully justified in insisting generally on the cost basis. Where the accounts are so kept, the rate of return on capital contributed to the enterprise is determinable. It is wholly impractical to keep accounts on the basis either of present values or on the basis of the cost of the various shares to their holders.

The charge that book values bear little, if any, consistent relation to cost is obviously an overstatement. It is true that there have been many departures from cost, some of which were not justified, but this scarcely warrants a wholesale indictment. Further, departures are to some extent necessary and justifiable unless the island of Manhattan is to be currently recorded at the $24 paid at its acquisition from the Indians. Upon bona fide transfer of ownership contemporaneous values must be recognized. In cases of loss or inability to earn an appropriate return on capital invested, a reduction must be made; in some cases appreciation must be recognized. Reorganization and recapitalization cannot be eliminated. It is essential, of course, that revaluations under these circumstances be properly made.

The propriety of the income return must be determined in the final analysis by the position of the individual stockholder, for it is only on the basis of his investment and his return that the latter may be said to be inadequate or "excessive." This has been recognized by no less an authority than the Ways and Means Committee of the House of Representatives in its report on the new tax bill. In recommending the earnings method as well as the invested-capital method for the determination of excess-profits taxes, the Committee points out that a consideration of income in its relation to invested capital alone is not sufficient.

"It is well recognized that there has been a large turnover in the stock of many corporations. The present owners in many instances acquired such stock on the basis of the earning record of the corporation at the time of purchase. To conclude that they have realized excess profits on the basis of what the original owners paid for the stock seems contrary to equity and justice."

The Margin of Corporate Income

The ratio of profit to selling price is not highly significant except for purposes of comparison within the industry. More important is the so-called "net product" i.e., gross value of goods and services produced less the value of raw materials and capital equipment consumed. This is in effect the portion of gross sales enuring to the benefit of employees, creditors, and owners, and is the figure used by the Department of Commerce in estimating national income. The figures indicate that corporate income over the period in question varied generally from 10 per cent to 18 per cent of the net product.

The most significant accounting fact observable in the study of income and "net product" is that of relationship to output or activity. Differences in profit margins appear to have been largely due to differences in the level of output relative to capacity. Accountants will readily appreciate the relation between income and the level of activity and the influence of fixed and variable costs on profits. In many cases the volume of business done is more important than the price at which the business is obtained.

The Distribution of Corporate Income

Corporate income is either retained within the corporate system or disbursed as dividends. Over the period surveyed, the corporate system has consistently paid out at least 50 per cent of its income as dividends, which averaged over $3,000,000,000 per year and amounted in the aggregate to 93 billion dollars out of a total reported corporate income of 102 billion dollars. These figures do not seem to sustain the claim advanced that there is a general tendency on the part of corporations toward "unreasonable accumulation" of corporate income. As to the recipients of corporate dividends, it is pointed out that there is a high degree of concentration of stock ownership; this phase of the study does not, however, involve accounting problems.

The Savings of Corporate Income

The savings of corporate income take two forms, i.e., the retained income and the portion of the dividends saved by the recipients. It is suggested, in Monograph No. 12, that well over 40 per cent of dividend income received by individuals with incomes of $5,000 or over is saved and that such savings are made possible by the high degree of concentration of dividend receipts. The evidence on which this conclusion is based is highly inconclusive; certainly no such saving is possible under recent or current income-tax laws. This is not, however, an accounting question.

Retained profits are properly regarded as savings. In Monograph No. 37

it is suggested that allowances for depreciation and depletion are also to be regarded as savings and therefore available for investment.[5] There has been a good deal of discussion of this proposition, and it has been severely criticized.[6]

To begin with, if the word "saving" is to be taken in its usual and ordinary connotation, depreciation is in no case a saving. Such corporate capital as may be said to be the equivalent of the accrued depreciation is offset by the diminution of capital represented by depreciable assets; it does not, therefore, represent an increase of capital in any sense. This is true whether the depreciation charge is earned or otherwise.

In dealing with savings, the economist may have in mind additional funds available for investment. In this sense, depreciation accruals may, in some cases, be regarded as the equivalent of savings. This is true, however, only in the case of those corporations which operate at a profit. There the capital representing accrued depreciation is in a sense a revolving fund for the replacement of worn out or discarded assets. All of this has been clearly and ably pointed out by Mr. May in his testimony and in the article cited above.

The Reinvestment of Corporate Income Savings

As indicated at the outset, the author of Monograph No. 37 compares the absorption of additional capital by the corporate system with the savings which the system makes possible, and finds that the savings are not fully absorbed within the system. The data used in this phase of the study does not appear to involve anything of direct interest to accountants.

Conclusion

While the studies under consideration do not indicate the necessity of any basic modification of current accounting philosophy, they show very clearly the need of providing machinery for improved assembly, tabulation, and reporting of accounting data. The material now available is far too fragmentary and incomplete to serve many useful and pressing purposes. As indicated above, accountants may well urge that such machinery be provided.

As to the current use of accounting data by economists, certain general observations may be made. In the first place there is something to be desired in the economist's understanding of accounting procedures. In addition, it may be fairly said that the economist is prone to draw conclusions from inadequate evidence—his freedom of action in this respect is likely to stagger any individual whose caution and desire for accuracy are as ingrained as those of the accountant. Finally, there is very strong evidence that economists in some cases, at least, use accounting data to support preconceived ideas rather than to reach sound conclusions.

---

[5] Monograph No. 37, p. 20.

[6] See, for instance, testimony of George O. May before the Committee, and his article entitled "The Relation of Depreciation Provisions to Replacement, LXIX, *Journal of Accountancy* 341."

What Is Cost?

BY E. B. WILCOX, CHICAGO, ILL.

Member of council, American Institute of Accountants

MUCH has been written and spoken in recent years to the effect that cost is the true and accepted basis of accounting, and occasionally cost has been referred to as a fact which can be verified objectively. It is, therefore, appropriate and timely to ask what it is.

When Jesus told Pilate that He had come into the world to bear witness unto the truth, Pilate said, "What is truth?" but he did not wait for an answer. He went out and said, "I find no fault with him." Today we have no Pilate who will ask, "What is cost?" and who, without waiting for an answer, will go forth and say he finds no fault with us. Instead we have a large audience that expects us to know what cost is, and that will definitely find fault in us if we cannot tell them what it is.

There is a school of thought that likes to deal with these simple profundities by searching the dictionary. Although I do not hold with these men, I have, in deference to them, read through nearly a column of fine print in my ancient Webster's. From this research I have culled a few gems: "The amount paid or engaged to be paid for anything bought." "Whatever is requisite to secure a benefit." "Loss or suffering." "Expenditure." There then follows under the heading of economics, a brief but eminently sound discussion of direct and indirect cost in production, concluding with this quotation from John Bates Clark, who became professor of political economy at Columbia University in 1895: "Cost is, in the last analysis, pain inflicted, just as utility is pleasure conferred." My dictionary then disposes of the matter with the cryptic words: "Syn.—see price."

I am inclined to agree with the professor from Columbia that cost is pain, not only because it is generally painful to those who incur it, but also because it is a distinct pain to those who must deal with it. If it were true, as some more recent writers seem to think, that cost is a simple fact, objectively verifiable, then its painful qualities would be limited to those who must pay. But that is not true. Cost is not a simple fact, but rather it is a very elusive concept. The familiar statement that accounting is an inexact science, stems in large measure from the indefiniteness of this basic element of accounting, and the pain of cost is shared in similar measure by the accountants.

Two aspects of costs which require separate consideration are costs incurred and costs expired. Costs are first incurred, and then, as their usefulness is realized, they expire. Expired costs appear in profit-and-loss accounts, and unexpired costs appear in balance-sheets, but all costs must first be incurred, and the determination of these costs at the outset is the first problem.

A few fundamentals offer but little difficulty. Costs are recorded and stated in units of money because these units provide an almost indispensable common denominator for accounting purposes. It would be difficult to conceive of a practical and useful accountancy expressed in terms of various commodities, without a single common denominator. Costs are historical in nature. Once a cost has been incurred, nothing that happens later can alter that fact. These two basic characteristics of cost seem comparatively immutable.

Second only to these characteristics in apparent stability are two more. First, costs expressed in dollars are not considered as having changed whenever the purchasing power of the dollar is seen to change. It follows logically from the fact that costs are stated historically in terms of dollars that the continued agitation for accounting that will reflect changing price indices shows that, on this point, cost, as currently understood, is not on all fours with absolute truth. Possibly we would be closer to the truth if we said that the cost of an article is the number of dollars which will purchase something else that could have been bought by the number of dollars paid for the article when it was acquired, but generally we don't.

The second of these apparently stable fundamentals is that cost is generally recognized on an accrual basis as an amount engaged to be paid, and not necessarily as a cash disbursement. Costs are thought of as being incurred when goods or services are received, and liability is assumed. But the simple illustration of a cash discount is enough to show that such amounts are not the same as cash disbursed. Nor can this simple matter be easily disposed of. Discounts taken are most commonly treated as items of income, but there are powerful arguments in favor of recording costs, net, and treating discounts not taken as items of expense. When the same item can be billed on either a net cash or a discount basis at the option of the purchaser, there is little guidance to be found in the invoice itself. In fact the decision as to whether cost should be recorded net or gross is as much a matter of the intent of the purchaser, as it is anything else.

Thus even such a basic concept of cost, as that it is a historical record of liability incurred in terms of dollars, is not without a degree of vagueness. Nevertheless, I think it is generally accepted and sufficiently understood to merit the status of a recognized convention. The real trouble comes when we try to apply this concept of cost to typical concrete transactions. I think the nature and extent of these difficulties will be most clear if we recognize that the recording of cost is, in fact, a problem in allocation and valuation, and that is what I propose to show.

At one extreme is the situation when mixed fixed and current assets, subject to various liabilities, are acquired by a new corporation in consideration of all of its common stock of no par or stated value. These net assets are purchased by the corporation, and a record is made of the transaction showing their cost. The directors of the corporation may place a value on the stock issued, thus determining the cost of the net assets. Or they may value the assets, thus fixing the amount to be recorded as paid-in capital. In either case it comes to the same thing; the basis of the record is valuation. The total values so established are customarily apportioned to the various assets and liabilities, and this is a problem in allocation or relative valuation.

This type of purchase is so different from a typical one, that it might almost seem not to establish cost at all. In fact, under certain conditions it does not establish cost as a basis for income-tax purposes. Neither will the recorded values stand up under attack, if it can be shown that they are fraudulent, and that the organizers or promoters established them to milk the company at the expense of creditors or others. These recorded costs are valuations, and as such their validity depends on their soundness and the integrity with which they are determined.

I think the important thing to realize in this connection is that cost is ordinarily established by an agreement between a buyer and a seller. Thus in any sale, cost is a matter of valuation: those values agreed on between the parties to the sale. It is assumed that, when transactions are conducted at arm's length, the agreed valuations are sound and have a significance worthy of recognition in accounts. But when the buyer is a corporation and the seller becomes a controlling stockholder in that corporation, the transaction can scarcely be said to have occurred at arm's length. It is true that there are legally two parties to the transaction, but these two parties are, for practical purposes, one and the same, and this one party agrees with himself as to values, and the corporation records a cost. This cost would probably be the same if the stockholder paid for his stock in cash, and then took the cash back in consideration for properties. The element in a transaction of this nature which is essential to the establishment of cost is not cash, but arm's-length trading or, in the absence of that, the adoption of values which can be shown to be sound and in good faith.

There are, of course, many variations to this kind of purchase. If the stock has a par or stated value, that value tends to indicate the cost involved, although it does not necessarily determine it. Preferred stock, and particularly preferred stock having call provisions, indicates costs somewhat more closely. The same thing is true of bonds, or of a combination of cash and securities. When a large corporation acquires a comparatively small property for part cash and part securities, there is present the element of arm's-length trading, and if the securities have a market value, the cost of the properties acquired is rather clearly indicated, but in the case of some public utilities, even cost established in this way may be set aside for certain purposes. Whatever particular shape this type of transaction may take, the element of valuation is always present.

There is an interesting situation in connection with properties acquired for securities having abnormally high interest or dividend rates, or call premiums. Once established, these financial costs are customarily treated as expenses, but they have a material effect on the amount for which the securities can be sold. When the securities are issued for properties, their sale price determines the cost of the properties. Thus decisions as to interest and call provisions, which would result in premiums or discounts on the sale of securities, also affect the recorded cost of properties, and management can, at its own discretion, allocate greater or lesser amounts to the recorded cost of properties acquired in this way.

Even when cash is promptly paid for mixed assets, the immediate statement of their separate costs presents a problem of allocation of the total amount. In the typical case of land and buildings, the solution to this problem governs subsequent depreciation, or loss on demolition, or determination of the cost of a new building erected on the site of an old one. Sometimes when the property or part of it is subsequently sold, the allocation of cost determines how much is a capital loss or gain for income-tax purposes. These allocations are important, they purport to record costs, and yet they are primarily allocations of total amounts, based on relative values of the parts of the properties acquired.

Turning to even simpler acquisitions, when properties are acquired for cash and are not mixed, the problem of allocation is still basic in recording costs. When a building is constructed by company employees, there is the necessary segregation of payroll, and the charging of materials and supplies from the storehouse, the question of application of factory overhead for shop work performed, and so on. When a building is constructed by a contractor, there are all the familiar questions of interest and insurance during construction, or the inclusion of the undepreciated cost of old walls used or not used. In nearly all building construction there are items of shelving, lighting, heating, and plumbing equipment, sprinkler systems, etc., which may or may not be legally part of the real estate, and which must be allocated either to the cost of the building or somewhere else.

When machinery is purchased, the base cost of the machine leaves little room for juggling unless cash discount is a factor. But when an old machine is traded in on a new one, the management must either record a profit or loss on the trade, in defiance of Treasury Decision 4422, or adjust the recorded cost of the new machine to reflect the undepreciated cost of the old one. Depreciation being no more than an estimate, cost, in this case, is also no more than an estimate. But even if no trade is involved, there are often items to be added to the prime cost of the machine. Freight and trucking are generally proper additions, but what if the company uses its own truck? Often foundations must be built, or wiring must be extended, and these items again involve allocations of payroll, supplies, and overhead. A particularly interesting problem arises when a machine is moved or rebuilt, and is thus rendered more useful. Frequently the costs incurred in such operations are added to the cost of the machine if the resulting total net depreciated cost seems reasonable, but are written off if it seems excessive. This is a clear case of recording cost on the basis of valuation.

It might seem that we would come to the end of this sort of indefiniteness when we consider the acquisition cost of ordinary items in inventories. Cost of raw materials or merchandise purchased can be stated rather definitely if questions of cash discount, freight, express, trucking, storage, interest, handling charges, etc., can be settled, but these are rather substantial questions. If such materials are received from an affiliated or subsidiary company, intercompany profit must be eliminated, and the question of where to allocate interplant transportation costs must be answered. But when we come to work-in-process and finished goods, there is, typically, no basis for stating costs other than allocation. The best that can be hoped for is an intelligently planned and competently operated system of cost finding, and this means that costs of items in the inventories are stated according to allocations of the various, and generally complicated material, labor, and overhead costs of a plant, many of which have been, themselves, determined by various more or less arbitrary allocations.

Whoever has been so fortunate as to know a near-by farmer who will sell fresh eggs at something less than the dairy price has probably bragged to a neighbor about the low cost he pays for superior breakfast food. It may be only jealousy, but that neighbor is apt to point out that the low cost quoted does not include gasoline and oil and other car expenses for the five-mile drive involved. Thus put on his mettle, the happy egg consumer will say that he likes to drive, and that the road to the farmhouse is exceptionally scenic. In fact, even if there were no eggs, his wife would want to go out there every Saturday, just for the view. This argument may occupy many a happy hour, originally dedicated to something else, but the upshot of it will be that the eggs are superior, and determination of their cost will go by the board.

In industry, determination of cost is not abandoned because it cannot be done accurately. The conventions with which we are all familiar are used, and that which results is labeled cost. This labeling is honest enough, and useful enough, but if we are to understand it, we must recognize that the processes by which the results are obtained are fundamentally those of allocation and valuation.

Thus far I have spoken only of acquisition costs or costs incurred, but these are only fleeting things. Whenever financial statements are prepared, incurred costs are separated into expired and unexpired costs. Some are immediately designated as expired, others are capitalized and amortized, and still others are segregated according to various inventory methods. Expired costs appear in profit-and-loss accounts; unexpired costs appear in balance-sheets. We have already seen how amounts are determined and grouped in allocating costs as they are incurred. Similar processes of allocation and valuation are used in determining expired and unexpired costs, the chief difference being that, in the latter case, the distinction is between periods of time.

Those costs which are immediately designated as expired are what we ordinarily think of as expenses. We all know that an officer's salary, if justified at all, results in benefits to future periods, yet we customarily record it as an expired cost when it is paid. Advertising has similar effects, and sometimes costs of advertising campaigns are deferred to future periods. When this is done, no one pretends that the allocation between months or years is accurate. It would be closer to the truth to describe it as symbolic. There is some effect on various periods, certainly, but it is too intangible to be measured. Perhaps the commonest deferred expense is unexpired insurance. This looks highly mathematical and accurate unless a policy is cancelled on short rates. Then, even this comparatively simple allocation of cost between periods is upset. In general, that group of costs described as expenses is customarily recorded in profit-and-loss accounts as expired, although the benefits from much of it are realized in future periods.

I will not greatly belabor the distribution of fixed-asset costs, as between fiscal periods. We all know that the useful life of such assets can only be approximately estimated, and that, given the useful life, there are various conventional methods of allocating charges to operations, such as straight-line, or replacement-reserve, or annuity methods of depreciation, and something called a scientific method which takes into consideration the probable increase in maintenance cost over the life of the asset. The purpose of these conventional methods is to record the expired cost of fixed assets in the profit-and-loss account, and to leave the unexpired cost in the balance-sheet.

In connection with fixed assets it is interesting to note that there is a widely recognized distinction between cost and appraised values. Generally, when appraised values are recorded, they are greater than depreciated cost. The resulting increase in recorded values is supposed to be segregated in an appraisal surplus account, carefully distinguished from earned surplus. Some of these cases are clearer than others, but all suffer from a measure of doubt as to whether the recorded increase represents appreciation of values, or an adjustment of prior year's depreciation. In the former case the customary treatment seems justified, but if the adjustment could properly be attributed to errors of judgment in recording depreciation in prior years, then the adjusted values would still represent undepreciated cost. In the face of such a situation we may well ask "What is cost?" Cost in the balance-sheet is an allocation to future periods of a part of certain historically recorded costs. If these costs have been written down by depreciation charges, and then up again by a subsequent adjustment, the question whether the result is all cost, or whether part of it is appreciation, is a problem in allocation and valuation.

I have already used most of the time allowed me, and have scarcely touched on inventories. Much has been written and spoken on this subject, and I shall attempt no more than to show that it, too, fits into my thesis that stating cost is fundamentally a problem in allocation and valuation. The Institute's committee on accounting procedure has indicated that the cost-or-market basis for inventories is justified because writing inventories down to market is, in fact, writing off a part of the cost which has expired. Thus inventories stated at market values, which are less than cost, are nevertheless stated at cost. The unexpired cost so determined is arrived at on a valuation basis, and represents a part of the historical cost. The words "cost or market, whichever is lower" imply a distinction which, it appears, does not exist. Possibly it would be better to describe this method of inventory valuation as "unexpired cost, after consideration of market values."

Both this method, and other cost bases, such as average, or first-in, first-out, or last-in, first-out, or base-stock, or any others, have for their purpose the allocation of historical costs between past and future periods. Each method is based on a particular fiction, and no one of these fictions ever quite exists, in fact. The average method implies that when materials are used or sold, they are taken from new and previous shipments, in the proportions which the respective available quantities bear to one another. Thus the remaining inventory is supposed to represent unused proportions of quantities acquired at various times, and possibly at various prices. The first-in, first-out method assumes that all old material is used before any new purchases are touched. This is supposed to have merit in approximating the actual physical flow of materials. The items last purchased are supposed to be on hand and are represented to be in the inventory at their actual specific cost. The last-in, first-out method takes the opposite view that incoming materials are promptly used or sold, or at least that we might as well pretend that they are, if the materials purchased and used are similar, and one merely replaces the other in the warehouse. The result is that operations are charged on a current cost basis, and the inventory is more like a fixed investment, stated at original cost. The base-stock method is similar in effect to the last-in, first-out method. Actually materials never behave quite as any of these methods implies that they do.

As recent literature on this subject shows, the relative merits of these methods present difficult and involved problems. It is not my purpose, here, to discuss these merits. The subject assigned me is, "What is cost?" In the balance-sheet, inventories may be stated on any of several cost bases, and the figure resulting from the basis adopted, is a cost figure. Its nature is that it represents that portion of certain incurred and historically recorded costs, which is represented as being applicable to future periods.

I can quite understand that it may appear, from all I have said, that I don't know what cost is, and that I think no one else knows either. I am not prepared to admit this. I believe that no one can say dogmatically that costs, in typical cases, are exactly so many dollars, no more and no less. I think that the margin of differences in the amounts at which costs of specific items may properly be stated, is too great to be ignored as trivial or academic. Certainly costs are an important basis of a large part of accounting, but they are no exception to the generality that accounting is an inexact science. Rather, costs are an example of this generality.

But I think I know the answer to the question, "What is cost?" Cost, in accounting, is a historical record of liabilities incurred expressed in units of money, which have been allocated to specific properties or transactions, and to various fiscal periods. Like other aspects of accounting, costs give a false impression of accuracy, and this false impression is heightened by the fact that the word "cost," itself, carries a connotation of something definite and determinable. To understand what cost is, it is necessary to understand that it is not definite. This means more than that accountants cannot arrive at accurate statements; it means that specific items of cost are inherently incapable of being stated, exactly. The determination of cost figures depends on the judgment used in selecting and applying conventional methods of allocation and valuation. The nature and meaning of cost, as recorded in accounting, is in these two processes, and an understanding of it is to be derived from them.

Some Aspects of Cost

BY RALPH C. JONES, NEW HAVEN, CONN.

Associate Professor of Accounting, Yale University;
Member, American Institute of Accountants

Cost is a protean word. Its habit of shifting its meaning with changes of context makes it a very handy, though rather slippery term. Like "value," to which it is closely related, it is a generic term applicable to a whole family of ideas. A number of definitions[1] could be cited, but they would not be particularly useful. The meaning of the word in the generic sense is well known. Implicit in the cost concept are ideas of sacrifice or sacrificing, of the giving up of something or of something given up, or of time, effort, money, or materials invested in or devoted to the production of goods or services. It would be futile to try to limit this broad concept to a single, precise meaning. Even if it could be done, another term, richer in meaning, would doubtless take the place of cost in common usage.

If one were called as an expert witness to define cost in accountancy, the most effective testimony would doubtless be a statement of what accountants do in determining and assigning cost in various factual situations. What accountants typically do, in other words, is more significant than what they say. A study of actual cost decisions made by accountants would reveal certain conflicts and inconsistencies comparable to those found in court decisions, but nevertheless, some well established and generally accepted practices, standards, or principles would emerge. Since these are at least as well known to you as they are to me, I do not propose to discuss them.

Another approach to the problem before us would be to consider the meaning of cost under various income-tax, fair-trade-practice, and national-defense acts. Urgent questions of cost determination under these laws are doubtless now before you, but the definition of cost for such purposes falls peculiarly within the province of the lawyer and the practicing accountant. In asking an academic accountant to discuss this subject, your purpose, I take it, is quite different. It is your purpose and mine to forget legal and technical details for the moment and to seek

[1] Cost: "The amount or equivalent paid, or given, or charged, or engaged to be paid or given for anything bought or taken in barter or service rendered.

"Economics: That which is sacrificed to obtain anything." *Webster's New International Dictionary.*

"Cost, in economics, means the surrender or destruction of value or the performance of some irksome activity as a means to the production of commodities or the acquisition of income. In a voluntaristic capitalist society the cost to an individual who contributes in any way to the processes of production may consist of an expenditure of money, of goods for which money could be obtained, of manual or mental effort irksome at the margin; or it may involve the assumption of a physical or financial risk, the acceptance of a role carrying with it social disesteem, the choice of the less attractive of alternative ways of employing time or resources, although none of the alternatives need be of itself displeasing or irksome." Jacob Viner. *Encyclopedia of The Social Sciences*, Vol. 4, pp. 466–467.

some clarification of the general concept of cost as it applies to accounting.

Many people, including perhaps a few accountants, think of cost in the absolute sense and assume that for any article or process there is one correct figure for cost. This, of course, is fallacious. There are different costs for different purposes. The cost, for instance, of driving one more mile in a car already owned, say two cents, is one thing; the average cost per mile of a year's driving, say six cents, is quite another. Both are correct and both are significant. The two-cent rate is pertinent in deciding whether it is more economical to drive or go by train on a given trip. The six-cent rate, however, is pertinent when the question is whether or not to own a car. The use of either rate for all decisions will lead to wrong conclusions.

Few, if any, accountants would admit adherence to the popular view of a single, all-purpose cost. Yet in action they sometimes seem to accept it. A complex cost system, for example, is installed after much argument over methods of allocation. At the time, everyone is acutely aware of the unavoidable compromises and arbitrary decisions made in the interest of feasibility. It is clear, while the system is being planned, that choices made among various plausible alternatives will definitely and perhaps substantially influence the results. The system goes into operation, however, and costs emerge with a superficial appearance of solidity and certainty which they do not in fact possess. To accept those figures as all-purpose costs is the easy way, and the temptation to do so is very great indeed, even among accountants who are aware of the difficulties and uncertainties involved in their preparation. For management, the problem is even more serious, since they must use the reported figures without the accountant's familiarity with the detailed computations.

The accountant on the one hand must recognize the needs of managers, economists, statisticians, and governmental agencies for different sorts of costs for different purposes. On the other hand, these users of accounting data must realize that the accountant cannot reasonably be expected to provide a different set of figures for every conceivable purpose. The accountant, however, since he is strategically situated at the source of the figures by which men act in our industrial society, must accept primary responsibility for the preparation and presentation of data which are really pertinent to the decisions which must be based on them.

While the accountant cannot be responsible for the unintelligent use or intentional abuse of his figures, he can do much to promote a better understanding of them. In more optimistic days, we may have thought that with an increase in the number of college trained men the problem would ultimately be solved if enough accountants had courses in economics, if economists generally had a course or two in accounting, and if business executives had courses in both. It is pretty clear by now that this is not true. A student can, and typically does, take courses in accounting and economics without integrating them in any significant way. What is needed is organized coöperation among mature workers in the various fields. It is just possible that a major function of the universities in the future may be the provision of facilities for such work.

The accountant, since he is interested primarily in the financial events of a particular entity and only secondarily in price determining factors in the economy as a whole, has been able to make little use of the economist's general classification of costs into rent, wages, interest, and profits. In recent years, however, economists have done much of their best work in the economics of the individual firm where the classifications and requirements are much closer to those of accounting. Some of these studies, indeed, are essentially cost accounting with a somewhat more imposing vocabulary. When these newer formulations of economic theory are more generally understood and appreciated by business managements, a demand will undoubtedly arise for accounting data which are more directly pertinent to particular decisions than the figures currently prepared. By anticipating this demand and by helping others to use his data wisely, the accountant now has an excellent opportunity to increase his prestige and value in the community. If he fails to do so, he may find himself in the company of those generals who still place their chief reliance on the horse. Incidentally, it would help if the economists themselves would gain something more than a superficial knowledge of accounting.

In his book, *Economic Thought and Language*,[2] Professor Fraser of Aberdeen University points out that the word "cost" is commonly used in two senses. He designates one concept as "embodied costs," the other as "displacement costs." Embodied costs are the technical factors of production which go into the making of an article—the units of material, hours of labor, and units of energy used in producing it and thereby incorporated or embodied in it. These factors may be stated in physical, psychological, or monetary terms. In physical terms they are not commensurable, while in psychological terms they are not even measurable. Psychological or pain costs can be ruled out at once, since they have had limited usefulness in economics and none, of course, in accounting. Standard costs are the best example of embodied cost to be found in accounting. They show the technical factors going into a product and give a sufficient indication of value to make them commensurable. An outstanding characteristic of embodied costs is the extreme difficulty of stating them in monetary terms. They relate fundamentally to technical rather than economic factors.

Displacement costs, in contrast, are what is given up for something, not what goes into it. The displacement cost of having some heavy bags carried by a porter would be the fifty cents paid him. The embodied cost would be the time and energy which the porter devoted to the service. Displacement costs are usually stated in terms of money, since the thing most commonly given up for goods and services is money. They can, however, be stated in "real" terms. In the railroad station perhaps you had to choose between having a cocktail or a porter. If you then decided in favor of hiring a porter, the cocktail in a very real sense was the price of the service received. Neither the cocktail nor the fifty cents, please note, were embodied in the porter or the service. The concept of displacement cost, thus, includes alternative or opportunity costs as well as purchase and exchange costs. Since usually the next best alternative to buying something is keeping the money which it would cost, displacement cost ordinarily is money paid out. Displacement costs, in summary, indicate possible economic consequences or alternatives, while embodied costs furnish information about techniques of production. Unsuccessful attemps to fit all ideas about cost into a single concept sometimes produce apparently irreconcilable arguments, both of which are correct: one, in terms of embodied cost; the other, in terms of displacement cost.

The typical accounting cycle consists of three steps: (1) the acquisition of assets, including units of service such as labor which must initially be regarded as assets no matter how ephemeral; (2) the transfer of these costs within the entity as operations proceed; and (3) the ultimate release of these

[2] Fraser, L. M., *Economic Thought and Language*, London, 1937.

costs as expenses, the costs of obtaining, or seeking to obtain, revenue.

Acquisition costs, the incurrence of which constitutes the first step in the accounting cycle, are necessarily displacement costs. Each incoming asset "displaces" an equivalent value whether payment is made immediately or later. Since cash or the promise to pay cash in the future is the usual consideration for goods and services acquired, displacement costs for the great majority of business transactions can be determined objectively within fairly narrow limits. This is true even when an assortment of assets is purchased for a lump sum. The cost is what goes out from the entity and that is usually determinable. The allocation of that cost to the individual items acquired, however, is another matter.

In non-cash transactions, difficulties of two types arise. One, of course, is the general difficulty of determining value on any given basis; the other is the problem of selecting an appropriate basis of valuation. The choice of basis in practice is generally between book value and current market value of assets given in exchange. Book value is convenient, and there is a certain plausibility in assuming that the unexpired costs of assets exchanged pass into or are embodied in new assets acquired. The unexpired costs which constitute book values, however, are merely summations of past transactions and may have little relevance to present conditions. The cost of a $25,000 house received in exchange for an oil painting, for example, could not properly be recorded as $10, simply because it was a Rembrandt which you happened to pick up for so little. Reverse the situation and the fountain pen you got for your supposed Rembrandt could not properly be recorded at a cost of $25,000. Even in ordinary situations, involving either depreciable or nondepreciable assets, book values are less reliable than values determined currently and independently, since the information available when an exchange occurs includes both the historical record and current factors as well. On theoretical grounds the book value of old assets exchanged may properly be shown as the cost of new assets acquired only when book value coincides with, or gives the best indication of, probable present value. The generally accepted basis [3] for cost determination, then, is the market value of assets given in exchange.

While the principle that the cost of an article is the market value of the consideration given for it is pretty generally accepted, it is applied with some uncertainty. A large American corporation, for instance, provides a bonus for executives, payable in stock. The total amount of the bonus is determined by formula in relation to the profits of the year. The number of shares to be distributed is then determined by dividing the bonus fund by the daily average market price of the stock during the year. The company pays this bonus by distributing shares of treasury stock acquired some years ago at a relatively low price. Now what is the cost to the company of the bonus? Is it the market price of the stock on the day of allotment, the average market price for the year, or the cost to the company of reacquiring the stock? The company in its reports to stockholders shows the amount of the bonus both on an average-market-price basis and a cost-of-treasury-stock basis, but uses the latter and much lower figure in the determination of net profits. According to the principle just enunciated, the cost of the bonus is the *value* of the stock distributed, not the amount paid out in acquiring it. The excess of the market price of the shares distributed over their cost when acquired some time ago as treasury stock should, if this analysis

[3] "Cost incurred is measured by cash outlay or by the fair market value of considerations other than cash." "Principles Underlying Corporate Financial Statements." *The Accounting Review*, June, 1941. p. 134.

is correct, appear as paid-in surplus, not as net profit. In computing taxable net income, the corporation should certainly be allowed to deduct the full amount of the bonus, not merely the cost of the stock distributed.

The second phase of the accounting cycle consists of tracing costs within the entity itself. This involves the original classification of costs and subsequent reclassifications or transfers up to the point of final expiration. From the moment when an asset, whether in the form of goods or services, comes into the entity, the accountant seems to apply a different concept of cost than the one he uses for transactions between the entity and the outside world. A bushel of wheat, for example, is purchased for one dollar. The historical fact, of course, is that at a particular moment in the life of the entity a bushel of wheat displaced a dollar. It would commonly be said that the entity invested a dollar in wheat, or by easy transition, that the entity *has* a dollar invested in wheat. Now the dollar is in the wheat and the entity still has it—an idea rather obviously contrary to fact. Presumably there is nothing in the wheat but wheat, and the entity certainly does not have the dollar. The assumption, however, that the dollar is somehow embodied in the wheat is convenient, useful, and even necessary to the functioning of an accounting system. The real embodied costs of the wheat up to the date of acquisition—the labor of growing, transporting, and marketing it—or their money equivalent cannot be ascertained. The price paid, however, is a fair indication of their probable amount and can, without undue violence to the concept, be used as an embodied money-cost. The price paid, a displacement cost, serves in other words merely as a convenient measurement or starting point. The concept after acquisition is that of an embodied cost and subsequent transfers within the entity regularly follow the pattern of embodied costs.

It is important at this point to distinguish between historical cost and embodied cost. Historical cost is a cost event occurring at a particular moment of time. Embodied cost persists through a period of time. My watch may have cost $50 some years ago. That is a definite historical fact, a closed transaction. But when as an accountant I conceive of fifty dollars as embodied in the watch I endow it with a kind of magic power; namely, the power to transmit that cost to other goods or services. If the watch is used to time a productive process, it is assumed that a portion of the embodied cost is transferred to the new product. Now in the economic sense the only transfer would be the *value* sacrificed in using the watch for the given purpose rather that not using it, an amount not dependent upon original cost. Moreover, when I embody the fifty dollars in the watch, I perform another feat of magic. I apportion this cost to wheels, mainspring, case, crystal, etc. In the economic sense, the only cost of an individual part of the whole watch assembly is the cost which could have been avoided by not buying that particular part, and unfortunately, the sum of such costs would most certainly not be exactly fifty dollars. In the process of applying the fifty dollar cost to the various parts of the watch, I have consciously or unconsciously gone into the technique of watch production. This is generally the case when costs are allocated to an assortment of assets purchased for a lump sum. It is a characteristic of embodied cost as distinguished from historical cost.

In the third and final step of the typical accounting cycle, these embodied costs become expenses, the costs of obtaining current revenues. This step, it should be noted, is exactly the reverse of the first. There goods and services were purchased with dollars; here dollars are purchased with goods and services. It is in this last stage of the accounting process that we find a direct collision between the two concepts of cost and, in consequence, the area of greatest confusion. Here embodied costs so carefully traced through the accounts are measured against revenues stated in displacement terms.

The advocates of the last-in, first-out and base-stock methods of inventory valuation may take comfort from the fact that consistency would require the determination of cost of sales on the basis of present values rather than embodied costs. In deciding whether or not to make a sale at a given price it is the *present value* of the goods or services to be sold, not their original cost, which is significant. This is so obvious in the case of shopworn, damaged, or obsolete goods that it is surprising to find so much doubt about the principle when it is applied to goods which have increased in value. It must be noted, however, that in comparing present costs or values with present sales, attention is focused upon one particular moment of time. The task of accounting is broader than this.

Accounting must report the results for periods of time, not merely successive moments of time. In other words, if cost of sales is to be charged with current or replacement costs, some method is required which will recognize value changes occurring between the moment of purchase and the moment of sale. If a business concern, for instance, sells for $10 an article with an original cost of $6 and a replacement cost of $7, the gain from making the sale rather than not making it may be $3, but that the margin to be accounted for is $4 can hardly be denied. Of this $4 margin it may be useful to call $1 appreciation and exclude it from gross profit on sales, but there is little warrant for neglecting it altogether.

The temptation is very great to make a digression at this point in order to discuss at length the controversial question of inventory valuation. For present purposes, however, it will be sufficient to indicate that base-stock and last-in, first-out methods are rule-of-thumb procedures for adjusting the accounts and statements for price changes of two very different types. Price changes of the first type, probably the more important historically, reflect changes in the general price level. They compensate for inverse changes in the value of the monetary unit and leave unchanged the total purchasing power of a unit of the given commodity. Thus an asset may have been purchased for $1,000 when the dollar contained 100 standard units of purchasing power, however determined. Subsequently it may have been sold for $2,000 when the dollar contained only 50 standard units of purchasing power. It is quite obvious, under the assumed conditions, that no gain in purchasing power occurred and the apparent profit of $1,000 is completely illusory, except for income taxes which unfortunately become capital levies when applied to such gains. It is equally correct to speak of the cost of the asset as $1,000 of the earlier year or $2,000 of the latter year. Both amounts are costs. It is hardly consistent, however, to determine profit by subtracting cost measured in big dollars from selling price measured in smaller dollars. Since it has not been feasible, for legal and other reasons, to recognize such dollar variations in the accounts, the pressure for the adoption of some rule-of-thumb solution has been very great.

Price changes of the second general type represent real changes in commodity purchasing power. In other words, prices of individual commodities vary while the value of the dollar in which they are expressed remains constant. Profits based on costs expressed in stable dollars clearly are real gains in contrast to so-called fools' profits which merely reflect changes in the monetary unit itself. But the base-stock and the last-in, first-out inventory methods treat both kinds of profit exactly alike. They eliminate both from the income statement.

Now in all the attempts to rationalize or justify base-stock and related methods, no one has ever shown that price appreciation in stable dollars, realized by subsequent sale, is not profit. It seems reasonable to conclude, therefore, that the exclusion of such gains from the income statement constitutes artificial stabilization of profits which in fact are not stable.

The essence of base-stock and related methods is the substitution of approximate displacement costs for the usual embodied costs in the trading section of the income statement. The effect is substantially to eliminate gains and losses from price changes in inventories whether these are real or illusory. In favor of such methods it can be said that they reduce profit distortion from price level changes without the complexities involved in adjusting embodied costs by means of index numbers, a procedure little understood and strongly opposed. Against them it can be said that they cause some profit distortion by concealing real gains and losses which cannot be ascribed to monetary factors. Since the elimination of one type of appreciation is thoroughly justified, while the elimination of the other is not, and since the separation of the two types is extremely difficult, the argument over methods of inventory valuation may be expected to continue unabated. Base-stock and related methods, it should be noted, apply displacement costs in only one section of the income statement, namely, the merchandise or trading section. It is probably impossible to apply such costs consistently to the whole aggregate of goods and services for which the customer pays in a typical sales transaction.

Which of the two concepts of cost is more appropriate for accounting? The answer is not easy, but it would seem that embodied costs, as defined herein, are the very essence of accounting. By basing his work on the concept of embodied cost, the accountant is able to furnish an account of stewardship, to record all costs incurred, and to trace them to their ultimate disposition. Product costs determined according to this concept are long-run costs representing amounts which must be recovered with some margin for profit if the entity is to remain permanently in business. Such information is of inestimable value. It provides a kind of bench mark for the guidance of management and for the appraisal of their effectiveness.

But even when embodied costs are recognized as essential in maintaining the continuity of the accounting process, it still remains true that such costs are not always appropriate or sufficient for decision making; in other words, for choosing among alternatives. The costs which are effective for a particular decision have been variously called alternative, opportunity, displacement, marginal, differential, or avoidable costs—terms which have some common implications though not identical meanings. In a manufacturing concern, for instance, a question may arise whether to operate a plant or department at reduced capacity or to shut it down completely, or whether to continue to sell a certain product or to withdraw it from the line, or whether or not to continue sales effort in a particular territory. In every case, the pertinent costs are those, and *only* those, which could be avoided by taking one alternative rather than another. Costs which must be incurred regardless of the alternative chosen simply do not exist so far as the particular decision is concerned. They are sunk, lost, or fixed costs—call them what you will—but they simply are not costs at all in relation to the issue at hand.

This principle, simple enough in its general statement, meets much opposition in practice, especially in relation to price cutting. The trouble, however, is not in the principle but in the application of it. A manufacturer estimates, for instance, that by reducing prices 10 per cent he can increase the number of units sold by 20 per cent. If his estimate is based on the assumption that the additional business will be taken away from competitors, it is probably wrong. But if it is based on a study of the elasticity of demand of the commodity, it is probable that the volume of the whole industry would increase 20 per cent at the lower price. If he is now making and selling 100 units at $1, the pertinent costs of the additional business are the additional costs of making and selling 20 extra units. But the revenue with which such costs must be compared is not 20 units at 90¢ or $18; it is $8, the dollar increase in total sales (120 x .90 or $108 minus 100 x 1 or $100 equals $8). If the additional costs exceed $8, the additional business is not profitable. But this is not all. If the larger volume resulting from the lower price will extend over future years, it may require permanently a larger plant and a larger organization. Under such circumstances certain fixed overhead costs must be considered. The principle of basing decisions on displacement or avoidable costs thus is sound, but the application of it is more complex than is commonly assumed. It is easy to overlook demand factors and certain long-run costs which may be pertinent to what seems on its face to be a short-run decision.

Applications of displacement, alternative, or avoidable costs in relation to any kind of business decision could be recited. A company, for example, is trying in a period of slack business to decide whether to accumulate an inventory or to reduce the rate of operation and lay off a substantial part of the working force. Among other things, the management will want to know how much of the company's funds would be tied up in the enlarged inventory. The plausible assumption that this amount would be the total cost of the inventory, computed in the usual way, would be wrong. The additional investment would include only the avoidable costs of manufacturing the additional inventory; in other words, the total costs, as above, less all apportioned charges which would have to be paid anyway whether the goods were manufactured or not. As a matter of fact, under such circumstances a pretty strong argument could be advanced for excluding these apportioned charges from inventoriable costs.

A problem involving the same principles arises in the opposite case of a company operating at more than normal capacity and employing labor at high overtime rates. Eighty per cent of the work, let us assume, is done at the regular rate of $1 an hour and 20 per cent at the overtime rate of $2 an hour. Now, if work on a particular order or article is done in overtime, it is apparent that a certain number of hours of work are embodied in the product; it is equally apparent that this work cost $2 an hour. While a strict application of the embodied-cost concept would require the charging of this amount to orders actually worked on in overtime, it hardly seems fair to do so since the selection of such orders is likely to be purely accidental. Many companies, therefore, resort to some sort of averaging by which the extra cost of overtime is spread over all orders. The average cost per hour of labor, assuming 20 per cent overtime at double pay, would be $1.20. The use of this rate as an embodied cost of all goods produced seems reasonable enough, but nevertheless it may be quite misleading. If the sales department uses costs computed at the $1.20 rate in accepting additional business, it may take orders at a loss. The significant cost is $2 an hour for *all* direct labor. If an order for any unit of product requiring one hour's work were canceled or declined, a charge of $2 for labor would be avoided. Any order, therefore, which cannot stand a charge of $2 an hour for labor shows a loss. The $2 rate, thus, properly applies to the total production whether carried out in regular time or overtime. Now, the accountant can hardly use the $2 rate for all goods produced, since to do so would result in the application of labor charges almost double the direct labor payroll. But if his averaging process serves to conceal essential facts from the management, he is rendering no service to them, to himself, or to the accounting profession.

The greater significance of current displacement costs for current decisions has naturally placed accountants under pressure to substitute them for historical costs in the formal accounts. Such substitutions have been made from time to time by revaluations of various kinds. A corporation buys a large tract of land, for example, for lumbering operations and pays $1,000,000 in cash for it. Shortly thereafter a valuable mine is discovered which a mining company tries to buy for $10,000,000, even going so far as to proffer a check for that amount. The lumber company, however, decides to keep the mine, to issue a $6,000,000 mortgage secured by the property, and to use this money to develop and operate the mine. Now, what was the cost of the mine to the lumber company? The orthodox accounting answer would be that some part of the original million dollars paid out is the cost of the mine. In a very real sense, however, the mine cost $10,000,000 cash just as effectively as if this amount of money had been paid out directly. And if the company cannot recover the whole $10,000,000 plus a reasonable profit, the decision to operate rather than to sell must be regarded as a mistake. The management is just as definitely responsible for the $10,000,000 as if this amount had been directly invested by the stockholders. Probably a majority of accountants would recognize this discovery value for balance-sheet purposes, even though under less dramatic circumstances they would insist on original cost. It is probable, however, that they would not think of the higher valuation as a genuine cost, which in fact it is. In this connection it should be noted that appraisals which merely compensate for fluctuations in the value of the monetary unit are also costs, but quite different in character. Properly conceived, they are adjusted historical or embodied costs, not current displacement costs at all. When adjustments of both types are recognized as true costs, many theoretical difficulties disappear, although complete consistency in accounting treatment is not likely to be achieved since the use of index numbers is quite complex and displacement costs are so uncertain and changeable that their general use is not feasible.

In summary, this analysis reveals a need for cost information of two distinct types, embodied costs and displacement costs. Embodied costs make such diverse elements as land, machinery, and labor hours conveniently commensurable. By being attached somewhat permanently to goods and services, they facilitate the process of tracing and matching, which Professors Paton and Littleton have described so well in their *Introduction to Corporate Accounting Standards*. Embodied costs, thus, are part of the continuous, long-run record of the life history of an enterprise.

Displacement costs, however, are needed in choosing among alternatives. They are pertinent and vital until a decision is made; then they become obsolete and die or lose their character by being embodied in particular assets. The decision itself changes the conditions and calls for a recomputation of displacement costs. While accounting can hardly make a formal record of these alternative costs, it can provide the data from which management may compute them.

Standard costs, which are embodied costs in the purest form, can be made especially useful for this purpose. It will be necessary, however, to modify the usual form of presentation in such a way as to separate the variable from the fixed factors. Standard costs typically appear rigid and fixed because they are merely summations of the average or normal costs of the various operations performed in the process of manufacture. As aggregates of averages they are subject to all of the statistical difficulties involved in dealing with averages. They could be used and interpreted with more assurance if they displayed more clearly the technical factors of production, not only the amounts of material and hours of labor, but also kilowatts of electricity and machine hours. By a careful separation of fixed and variable factors, the standards could be made to show costs at various rates of operation and under varying conditions.

Consider power costs, for example. The total requirement in kilowatt hours for all operations in the manufacture of a part could be shown along with the variable and fixed costs of power. Then, if the company buys electric power at usage and capacity rates, the management could ascertain the effect on power costs of manufacturing the part during the peak or off-peak periods. Likewise, if fixed and variable overhead rates were shown, the effect of making a larger or a smaller quantity at various rates of plant operation could be determined. In other words, instead of a fixed and rigid cost applicable only under an assumed normal which is seldom if ever attained, such standards would be a dynamic instrument by which the management could estimate the effect of substituting one material for another, of using higher or lower priced materials, or a change in wage rates, or of a change in the rate of plant operation. Marginal costs, average replacement costs, and other types of cost could be determined within fairly narrow limits, all without complicating the regular accounting process in the slightest. It might be well, as a matter of fact, to furnish the sales department with no other type of cost since unit costs, when reported in the usual way, have a solid look which tempts the user to forget the unstable averages and doubtful assumptions upon which they rest. Certainly the basic assumption that costs are transferred within the entity according to physical, spatial, and temporal relationships rather than economic consequences or alternatives, although reasonable and necessary for the accounting process, is not valid for all purposes.

Similarly, the behavior of the total costs of enterprise operation in relation to changes in volume deserves more careful study. Analytical reports on such behavior are more vital to management than a mere historical record to be compared with similar records of the past and then filed. Professor R. L. Dixon, Jr., makes the interesting suggestion [4] that the income statement itself be recast to show fixed and variable expenses instead of, or in addition to, the usual classifications. This may not be feasible for published reports unless some fairly objective method for separating the fixed and variable elements can be developed, but certainly internal reports on cost behavior are desirable. Flexible budgets are used to a certain extent, but the study of cost behavior in general has not been adequate.

Since the word "cost" practically blankets the fields of accounting and economics, it is not surprising that this paper should touch upon widely scattered points. Controversial issues, on which the author reserves the right to change his mind, are strewn along the way. The intention has been to show that the cost concept is broader than is generally recognized and includes much that is commonly spoken of as value. The recognition of certain types of value as true costs should help to clarify their accounting treatment. Further, by recognizing the two broad concepts of cost, the accountant should be able to make them useful servants rather than fertile sources of confusion.

---

[4] Dixon, Robert L., Jr., "Fixed and Variable Costs," *The Accounting Review*, June, 1940, pp. 218–222. Also *The Income Statement* (unpublished), Yale University Library, 1941.

TERMINOLOGY

Chairman: WILLIAM D. CRANSTOUN *September 17, 1941*

Introduction

BY WILLIAM D. CRANSTOUN, NEW YORK
Member, committee on accounting procedure,
American Institute of Accountants

THE committee on accounting procedure of the Institute in its Bulletin No. 7, issued in November, 1940, presented two reports of the committee on terminology, a committee which had been constituted during the year from the membership of the larger committee. The first of these reports, which no doubt you all have read, contained a statement of the new committee's conception of its work and program with relation to accounting terminology. That statement reviewed the reports of previous committees and found that the words and phrases defined by those committees fell into four classes which were described in the following words:

"First, there are words or phrases that are fundamental and are used in accounting in senses more or less at variance with the senses which attach to them in the public mind. (Value, assets, liabilities, surplus, etc.) Second, there are a small number of purely technical terms developed by accountants and unfamiliar to the public, such as balance-sheet, double entry. Third, there are words originating in other fields, particularly law and business, with which the accountant is frequently concerned. Fourth, there are terms used in auditing as distinct from accounting."

The report of the new committee then expressed the belief of its members that their efforts should be primarily directed to the words or phrases in the first class and to a few in the second class.

Every professional or scientific group finds it necessary to develop a language of its own. The peculiar experiences of each group require new words or terms or add to the meaning of words or terms already in use. As a terminology becomes established firmly, exchange of ideas within a group is facilitated. But if understanding of its work by outsiders is to be expected at all, that cannot come until the language of the group is learned by the outsiders.

There are groups of people, artistic, scientific, or otherwise, who seek to protect their claim to peculiar knowledge or skill by mystifying the public with words and terms whose meaning is known only to the initiate. Accountants, however, must seek to achieve an opposite result. Their professional efforts are directed to the production of statements and reports which are prepared for the information of the layman. If these statements and reports are misunderstood by the public, the efforts of accountants will be defeated, and yet misunderstanding is bound to occur unless accountants employ language the meaning of which is clear to those for whose information the reports are intended.

Obviously, our terminology can only be understood by the public if it is used intelligently and consistently by the profession, and that requires that accountants themselves agree on the meaning of terms. In seeking to bring about agreement as a prerequisite to public understanding, the committee felt that its first task might well be to prepare a discussion of the specialized usage in accounting of common terms which should not be limited to mere definitions and might even include suggestions for the modification of present practice. Such a discussion, it was believed, would be useful not only for circulation in the profession but also in leading to recognition of special meanings in new editions of general dictionaries.

As the committee on terminology believes that its most promising field of activity lies in the consideration of "words or phrases that are fundamental and are used in accounting in senses more or less at variance with the senses which attach to them in the public mind" and "a small number of purely technical terms developed by accountants and unfamiliar to the public," it is clear that its initial efforts should be directed to the most important of the words, phrases, and terms included in these classifications.

Your attention this afternoon is to be directed to the reasons why certain of these require explanation and definition. Without encroaching on the ground to be covered by the speakers on this program, it may be observed that the need for establishing a common understanding on the meaning of words and terms between ourselves and the public is urgent. One needs only to be acquainted with the trial in our courts of cases involving accounting statements and reports to realize the difficulties confronting accountants testifying in regard to financial or accounting matters. The real significance of financial statements seems often to be beyond the grasp of judges and attorneys and, in such a situation, the accountant is always at a disadvantage.

In a case recently tried in a court in New York State, the judge made it abundantly clear that he did not see eye to eye with the testifying accountant on the significance of balance-sheet values, and declared that the opinion of other accountants differed from the one testifying.

The confusion resulting from failure to understand the purpose and meaning of financial statements and the basis for the figures contained therein rests largely on the misinterpretation of the language accountants use. The correction of this situation requires the education of the public in that language. We cannot start, however, with a campaign of public education until we ourselves agree on the meaning of terms and words which we use. We must agree on those which are employed in any sense differing from their general meaning and must agree on what they signify in their accounting application. The profession must agree on the meaning of terms which they themselves have created. Lack of agreement has been often a cause for embarrassment to the profession. How can we expect understanding from others without this agreement?

The first step in establishing a common recognition of the meaning of words and terms as accountants employ them is a decision as to the words and terms which require studied consideration. That thought is responsible for devoting part of the limited time available at our annual meeting to a general discussion of why certain words and terms need specific definition in their application to accountancy.

Specific Accounting Definitions

By Harold W. Scott, Detroit, Mich.
Member, American Institute of Accountants

When I was invited to participate in this session on terminology, my first reaction was to refuse because it seemed rather a waste of precious time, in momentous days such as these, to set aside a period at the annual meeting of the Institute for the consideration of mere words and phrases. However, after searching among the accounting authorities for a few words to discuss, I am convinced that accountancy definitions badly need standardization to lift them from the maze where confusion and contradiction still exist, that the committee on terminology should carry on with its good work, and that this hour will not be spent in vain.

The first term which I am going to discuss is our old friend "working capital," or—to start the confusion—perhaps I should say "*net* working capital." From a review of accountancy textbooks the conclusion was reached that the most commonly stated definition of working capital is substantially "the excess of current assets over current liabilites." However, this definition is quite apparently not acceptable to all authorities, because other definitions are also given, and we frequently find even that those who seem to have accepted this definition also use the term "net working capital." If working capital in itself represents the excess of current assets over current liabilities, it is difficult to understand what "net working capital" represents.

In his recent book entitled *Advanced Accounting*, Professor W. A. Paton sets forth forms for a so-called "Statement of Working Capital" in one of which he deducts current liabilities from current assets to arrive at net working capital. In another form he deducts current liabilities from so-called "liquid assets" (cash, receivables, etc.) and calls the difference "excess of liquid assets." To this so-called "excess" he *adds* other current assets and calls the sum of the two "net working capital." In the text matter he speaks of "gross working capital" as apparently being synonymous with current assets and of "*net* working capital" as representing the difference between current assets and current liabilities. Thus he has both "gross working capital" and "net working capital" but apparently has no figure which could be designated merely "working capital." One is thus led to wonder, what is working capital?

Exception to the generally accepted definition of working capital is taken in the 1933 edition of the *Financial Handbook*, edited by Robert H. Montgomery. While in the 1925 edition working capital is defined as "the excess of current assets over current liabilities," the definition is changed in the 1933 edition to read "current assets, or assets which in the normal course of business are turned into cash," and "net working capital" is defined as "current assets less current liabilites." The *Handbook* explanation indicates that the time-honored definition of working capital—the excess of current assets over current liabilities— is now obsolete. However, I am afraid that all other authorities have not accepted this view. With reference to the word "working" and the definition given for "working capital" in the *Handbook*, it is rather interesting to note that the same volume defines "working assets" as a term "descriptive of assets intermediate in character between capital and current assets; specifically, assets which are consumed by an enterprise in the activities carried on without themselves forming an integral part of the product; e.g., supplies used in operations." Also, Professor Paton, in one of his earlier textbooks, and other authors impose a similar restriction on working assets. If "working assets" are thus confined, how is it possible to explain to the layman that the mere change of the word "assets" to "capital" results in embracing cash, receivables, and finished product?

Much of our difficulty seems to lie in agreeing upon a definition for the words "capital" and "working." Those who use the more traditional definition of working capital as "the excess of current assets over current liabilities" apparently have the accounting definition of "proprietors' capital" in mind, while those who consider working capital as "the total current assets" are thinking of capital in its economic sense as representing the portion of all capital, whether owned or borrowed, which is used in current operations. Inasmuch as an attempt is seldom made to deduct long-term liabilities in defining fixed capital, is it not more logical to include both borrowed and proprietors' capital in defining working capital? As a matter of fact, in the case of a going concern the so-called "working capital" furnished through current obligations is almost as permanent, and usually just as available, as the proprietors' capital, because the current liabilities probably will not be diminished in total amount.

The confusion in the mind of the average businessman when the accountant refers to working capital and means the excess of current assets over current liabilities is quite understandable. In the face of a considerable growth in volume of business and large increases in cash, receivables, and inventories, as necessary for such business, it is difficult to convince the executive that he has less working capital because the current liabilities at a particular date have increased in greater amount.

In conclusion, it would seem that if we are to use the word "working" in connection with "capital" and mean either total current assets or even current assets less current liabilities we should not define "working assets" as merely supply inventories, or assets of similar nature, as is done in numerous standard works on accounting. One is led to wonder why we do not use the terms "current assets," "current liabilities," and "excess of current assets over current liabilities," all of which have generally accepted meanings, rather than attempt to use the terms "working" and "capital" when referring to either current assets or the excess of current assets over current liabilities. It is recognized that there often are grounds for including in working capital certain items which may be excluded from current assets on the balance-sheet, such as prepaid expenses, but as a matter of practical application so-called statements of working capital usually include only the current assets and current liabilities as they appear on the balance-sheet.

Since the enactment of the various laws administered by the Securities and Exchange Commission the necessity for a more specific and limited definition of "funded debt" has been emphasized, principally because of the requirement under Regulation S-X that schedules of funded debt be furnished in registration statements and annual reports.

The definition for funded debt appearing in the various instruction books of the S.E.C. is quite vague and unspecific, reading that "the term 'funded debt' refers to indebtedness having a maturity at the time of its creation of more than one year, independent of acceleration." The Interstate Commerce Commission also defines funded debt as "unmatured debt, maturing more than one year from date of issue." The dictionaries are just as vague—Funk & Wagnalls' *Standard Dictionary* definition for "funded" reads "converted into a permanent loan or into bonds and the like payable at a future time with interest; as a 'funded debt'"; while Webster's *International Dictionary* reads "a fixed liability (called also, funded debt, funded liability) is a liability such as a bond or debenture which does not mature for at least one year from the date incurred."

The majority of the accounting authorities also seem to consider that "fixed liabilities," "long-term debt," and "funded debt" are synonymous and that the principal element of distinction is the term—that maturity be longer than one year. In the *Accountants Handbook* the statement appears that "obligations with maturities of more than one year are usually considered fixed" and following thereafter is some discussion of funded debt. The *Financial Handbook* does not define funded debt, but states that "liabilities which are due more than a year hence are fixed liabilities." In *Auditing*, by W. H. Bell and R. S. Johns, appears a somewhat all-inclusive definition of funded debt, reading as follows: "The distinguishing feature of funded debt is its term. The expression 'funded' is generally understood as applying to obligations maturing in more than one year from the date of issue, regardless of whether or not they are secured. Funded debt is, therefore, practically synonymous with long-term debt. The obligations may be bonds, debentures, long-term notes, certificates of indebtedness, or mortgages; or they may perhaps be otherwise described without being essentially different from one of these."

The committee on terminology of the Institute in its 1931 booklet also uses the one-year rule in making a distinction. Under "Capital Liabilities" is included "obligations, under seal or otherwise, which, according to their terms, do not mature until more than one year from date of issue (commonly known as 'funded debt' or 'long-term debt')" and the booklet further states "the period of one year is an arbitrary one adopted by accounting regulatory bodies as the dividing line between 'funded debt,' (or 'long-term debt' or 'fixed liabilities') and 'floating debt' (or 'current liabilities') and it is recommended that accountants consider the universal adoption of this plan for the sake of uniformity."

The question now arises as to whether we should not have a more restricted definition of funded debt and whether definite tests other than the "term of the obligations" should not be imposed. This seems particularly desirable in view of the requirements of the Securities and Exchange Commission with respect to balance-sheets and supporting schedules. If the S.E.C. intended that all obligations with maturities of more than one year be classified as "funded debt," why in Regulation S-X is there provision made in the balance-sheet instructions for commercial and industrial companies for "other long-term debt," with detailed instructions that long-term debt not provided for under "funded debt" and "indebtedness to affiliates—not current" be shown; indicating whether secured and showing the maturities for the five years following the date of the balance-sheet? Likewise the column headings in the schedule of funded debt under rule 12.10 seem to apply to obligations in the nature of bonds, debentures, or notes used for the purpose of borrowing capital and are not adaptable for showing information with respect to such items as ordinary purchase-money mortgages, land contracts, or similar obligations.

We should be furnished with a more specific definition of funded debt, and such definition should be made acceptable to accountants, lawyers, and the Securities and Exchange Commission. In reviewing various registration statements and annual reports to the S.E.C. it is noted that the schedules of funded debt are marked by inconsistency in treatment by lawyers and accountants. In certain cases items such as purchase-money mortgages and land-contracts payable have not been shown in the schedule. In other cases an attempt has been made to fit a description of such obligations, and even taxes and other contractual obligations payable after one year, to the column headings provided. In still other instances the word "none" has been inserted under the column headings with an explanation below to the effect that while the company denies that it has any funded debt, it does have the following long-term liabilities, and then describes such obligations as named above. This latter form of "fence straddling" seems to be a favorite with attorneys when confronted by the question as to what the Commission means by "funded debt."

Through usage, the term "affiliate" or "affiliated company" has been given a meaning in accountancy which has been generally accepted by accountants and which is probably well expressed in the definition under the securities acts to the effect that "the term 'affiliate' or 'affiliated,' used to indicate a relationship with a particular person, refers to a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such person." However, I believe that the ordinary businessman or other layman has not yet accepted such a restricted definition of affiliate and is inclined to the ordinary general definition under which an affiliate is a company closely connected through an alliance, contractual arrangement, or kindred interest, and not necessarily through stock ownership under which control is exercised, although the latter would be recognized, of course, as one form of affiliation.

The dictionary definitions do not indicate that the element of control is necessary and in most cases no distinction is made between an "associate" and an "affiliate." Accountants have favored the use of the former term when companies are closely connected, perhaps through an operating or other contractual arrangement, but the element of control is not deemed to exist. The term "associated company" has also been used by accountants when referring to a company in which an exact 50 per cent stock ownership is held, with the other 50 per cent held by another single interest. In a recent case of this nature where the lawyers and accountants for one of the owning companies were taking the position with the Securities and Exchange Commission that affiliation did not exist, because each of the owning companies (which were not otherwise connected) held one half of the stock and each was represented by one half of the board of directors and therefore neither could exercise control, the president and other officers of the company continuously referred to the so-called "associated company" as an "affiliated company," even in the company's annual reports to stockholders, to the discomfiture of the technicians handling the matter before the S.E.C. This situation was not caused by any lack of understanding as to the existence or nonexistence of control but because of a different interpretation of the word "affiliated."

Even accountants do not always distinguish between "associated" and "affiliated." In the *Accountants Handbook* a definition of affiliated company does not appear, but it is indicated in the index and text matter that the terms "associated company" and "affiliated company" are synonymous. The *Financial Handbook*, after stating that corporations are affiliated if "controlling, controlled by, or under common control with," indicates that corporations may be affiliated without any actual or legal means of control such as "companies promoted as separate and independent concerns by officers of corporations to take advantage of opportunities created by these corporations."

It would appear that if accountants are to use the word "affiliate" as indicating control, usually through stock ownership, steps should be taken to educate the business public to the same usage. Otherwise it would be preferable to use the more specific terms of "parent company," "subsidiary company," "controlled company," or even "commonly controlled company."

To add to the confusion it is of course recognized that under the internal revenue acts the term "affiliated" has a highly specialized meaning with definite percentages of stock ownership stated.

Accounting Meaning of Income

BY STEPHEN GILMAN, CHICAGO, ILL.

Member, committee on publication,
American Institute of Accountants

THE midyear 1941 report of the Institute committee on terminology gave thoughtful consideration to accounting uses of the word "income," without, however, making any definite recommendations in favor of its substitution for "profit."

Nevertheless, the committee called attention to a substantial number of corporations using the word "income" in published reports. Since such usage differs from the usages in law, economics and taxation, either an accounting definition of "income" is required, or the word should be eliminated from the accountant's vocabulary.

In this present inquiry, consideration is given to the one word "income" unmodified by "gross," or "net," or "operating," or other adjectives which do not aid in clarifying the basic problem of definition.

Legal, Tax, and Economic Viewpoints

First, let us consider the meaning of "income" to the economist. Irving Fisher tells us that economic opinion regarding income is "deplorably confused and conflicting." Out of this welter, however, four points emerge: (1) the economist seems to be interested in income primarily in relation to natural human beings; (2) in his concept of income the economist includes certain imputed items for which the accountant finds no place, and at the same time eliminates items which the accountant invariably thinks of as true costs; (3) the economist rejects the accountant's historical costs as "water over the dam," and argues that only present or future costs influence economic behavior; and (4) while recognizing money as one method of *measuring* income, the economist is likely to think of income in nonmonetary terms, as consisting of the *services* provided by capital and labor. With reference to this fourth point, some economists would say (1) that two men with equal money incomes would not have the same economic incomes if one saved and the other spent and consumed, or (2) that one man with the same money income in two successive years would not have the same economic income if the purchasing power of money had changed.

Turning to the legal and tax viewpoints, we find them shaped largely by a Supreme Court definition of income in the famous case of *Eisner* v. *Macomber*. One central element of the definition is that of *severance*—a gain must be *derived* or *severed* from capital in order to constitute income.

In this respect we can agree that the legal definition conforms substantially to accounting thought. But in other respects there is divergence. For example, Congress, which admittedly is not accounting-minded, has the power to define income, as a result of which every tax accountant can name important ways that taxable income differs from business net profits.

Difficulties Caused by Shifting Points of View

Much confusion as to the significance of the word "income" results from failure to consider the question, "Whose income are we talking about?"

As just explained, the economist is apt to think of income in terms of the purchasing power of *natural persons.* To him, the business entity in any form is little more than a way-station in the march of income toward its final enjoyment.

The lawyer, too, thinks of income in terms of natural persons but with one notable exception, that exception being the corporation, which is regarded as an artificial person.

The accountant, however, is largely concerned with business enterprises and is apt to think of income only in terms of money and in relation to a business entity, regardless of its type of proprietorship.

It is in these three viewpoints toward the question, "Whose income are we talking about?" that we may find a key to conflicting definitions.

Is Income Net Profit

While it could be argued that we can find no exact accounting equivalent for income, it is believed that this discussion can best be built around the following three questions referring only to approximate similarities: (1) Is income net profit? (2) Is income gross profit? (3) Is income revenue?

It is no criticism of various Institute publications to say that they have used "income" in each of these three ways. Probably we all do the same thing. Generally, however, our publications march with those authorities who hold that income is substantially equivalent to net profit. This thought is suggested by the economist, Fabricant. It is clearly implied by Messrs. Paton and Littleton. It is definitely stated by Henry Rand Hatfield, who says he "has vainly tried to find any accepted differentiation" between income and profit.

The 1931 report of the committee on terminology asserts that income is "increase in wealth measured in money as distinguished from return of capital." The present committee somewhat confirms this view, mentioning the importance of recognizing the composite nature of income as the resultant of positive and negative elements, a combination of words suggesting that income is similar to net profit.

Finally, the Institute's leaflet "Financial Statements—What They Mean" designates profit transferred to surplus, as "income."

Is Income Gross Profit?

While the unmodified word "income" as used in taxation is somewhat of a hybrid, it may be said, rather broadly, that as far as its manufacturing or trading aspects are concerned, income is somewhat equivalent to gross profit (deductions therefrom being more a matter of Congressional grace than of accounting or economic logic).

Roswell Magill says that income of an individual consists of his total gross receipts after subtracting costs from the proceeds of any sale. Elsewhere he insists that the cost of goods sold must be allowed as a deduction in order to arrive at income, but he does not, of course, express himself with certainty as to the status of business expenses.

The exclusion of certain expenses necessary to create taxable income was a central point in the famous *Higgins* case.

From the accounting angle we note

the unpublished tentative report of the committee on terminology, dated 1936, which defines the phrase "income statement" as "a summary of the income and expenses. . . ." Two recent Institute publications—"Accounting and Your Pocketbook" and "Financial Statements—What They Mean"—employ the same phrase. That phrase, with its omission of the word "costs" and its emphasis on "expenses," imports but one thing: the general equivalence of income and gross profit.

Is Income Revenue?

We find some support for regarding "income" and "revenue" as practically synonymous.

One definition of income, given in Webster's *New International Dictionary*, is, "Commercial revenue or receipts of any kind." (Also, among the synonyms we find the word "proceeds.")

One of the three definitions in the *Encyclopaedia Britannica* refers to income as, "'incomings' in the form of money (including payment in kind)."

Several of our largest corporations use the word "income" in a manner which supports the theory that income and realizable revenue are the same. This is intimated in annual reports of the Johns-Manville Corporation, the Continental Can Company, Inc., Lane-Wells Company, and others.

Even more interesting to this audience is the implication that income and revenue are substantially equivalent, as indicated by this combination of words: ". . . the income received and the expenditures made . . ." from page 30 of "Examination of Financial Statements by Independent Public Accountants."

Our publication, "Financial Statements—What They Mean," certainly suggests that income is revenue, by saying that the income statement "matches the costs of doing business against income earned."

Finally, we have confirmation in Accounting Research Bulletin No. 8, in the following words: "Over the years it is plainly desirable that all costs, expenses, and losses of a business other than those arising directly from its capital-stock transactions, be charged against income." Here there can be little doubt as to meaning. There is only one figure on the profit-and-loss statement against which all costs, expenses, and losses are to be "charged," and that figure is revenue from sales or service.

Conclusion

Since it is doubtful that many accountants will argue for the equivalence of the unmodified word "income" and *gross* profit, it is unnecessary to give further consideration to this concept.

Instead, they show a strong tendency to regard income, whether or not qualified by the word "net," as being a *net* item. If the accounting profession adopts any definition of income it will doubtless be one of this type. It may be urged, however, that the accounting profession should avoid using or defining the word "income" on the ground that any definition acceptable to accountants would be so unlike economic and legal usages as to create unnecessary confusion.

As accountants, we cannot adopt a definition of income save one which is based solidly (1) on money, (2) on historical costs, (3) on realization, and (4) on the concept of an accounting entity. We cannot give consideration to the personal enjoyment which money income gives to individuals, nor to changes in the purchasing power of money.

We cannot go far along the lines of legal thinking, since in all fairness to the businessmen, who are our clients, we must adopt a philosophy and language of profit and loss which is not dependent upon political definition or tax expediency.

It is not as though we had no other

word which could be used. We have a tested, tried, and true friend; one with strong accounting implications; one to which businessmen have become accustomed; namely, the word "profit." It is a word which has an opposite, namely "loss," an advantage which, as the present committee on terminology has noted, does not apply to the word "income."

Turning next to the third possibility, we may doubt that the accounting profession will ever define "income" as being substantially equivalent to realizable revenue. Nevertheless, in all fairness it should be pointed out that the accountant's preoccupation with the business entity as an artificial person somewhat justifies such a usage, there being a supportable analogy between the income of a natural person and the realizable revenue of the artificial person or entity with which the accountant deals. Such usage would, it is believed, be clear to individuals, whether in their capacity as stockholders, employees, or creditors. There is sufficient public misunderstanding of accounting terminology to justify giving substantial weight to this argument.

In summary, therefore, it seems that we should decide either to refrain from formulating any accounting definition of "income" or else define it as generally equivalent to realized revenue of an accounting entity.

Intangible Assets and Contingent Liabilities

BY THOMAS M. DICKERSON, CLEVELAND, OHIO

Associate, American Institute of Accountants;
Head, department of accounting, Cleveland
College, Western Reserve University

I SHOULD like to direct your attention to two types of items usually found on a balance-sheet, the definition and treatment of which are often vague, confusing, misleading, and wholly lacking in uniformity. I refer to intangible assets and contingent liabilities. I have read much of what has been written by authors of textbooks and by practicing accountants concerning these two groups of accounts, and I am impressed by our more or less vague and incoherent attempts at definitions and by our lack of uniformity in the suggested classification of these items in the accounts and statements. About the most uniform feature of all published financial statements seems to be their lack of uniformity in the treatment of intangible assets and contingent liabilities. Most of this lack of uniformity in textbooks and published financial statements can be traced directly to our loose definitions and careless uses of these terms. Therefore, I suggest that the Institute's committee on terminology prepare definitions of these terms which may be acceptable and which may be interpreted and used with more uniformity.

Intangible Assets

Let us direct our attention first to that group of accounts covered by the term "intangible assets." Strictly speaking, intangible assets include *all* those which are not tangible, that is, all those which do not have physical or material existence. Intangible assets consist of rights and advantages possessed by a business. They vary greatly in nature from bank deposits and accounts receivable, which are enforceable claims for exact amounts of money against known individuals, to secret formulas and other trade secrets, which represent no enforceable claims for any specific amounts against any particular individual. Between these two extremes we find a great many assets which vary in their degree of intangibility.

For the purposes of arriving at usable definitions we may classify intangible assets into three groups:

1. Those which represent *legally enforceable claims* for exact amounts against known individuals; e.g., bank deposits, and accounts and notes receivable.
2. Those which represent *exclusive legal rights*, the ultimate value of which cannot be determined in advance, nor can they be enforced against any particular individuals; e.g., patents, copyrights, franchises, and leaseholds.
3. Those which represent *capitalized probable future earning power* in excess of a fair return on the investment in tangible assets of a particular business; e.g., goodwill, secret formulas, and even organization expenses.

I believe any attempt to formulate a general definition for the term "intangible assets" is impracticable. As a matter of fact, the definition should exclude specifically from its scope the assets included in the first group mentioned above, i.e., bank deposits, and accounts and notes receivable. The almost universal practice is to classify those items as current assets. After specifically excluding the above group of items, our definition of intangible assets, or an accompanying explanation thereof, should indicate clearly the desirability of differentiating between the second and third groups mentioned above. We should recognize the different accounting treatment applicable to patents, copyrights, franchises, and leaseholds, from that applicable to goodwill, secret formulas, and organization expense.

The assets in the second group represent legal rights, the duration of which are definitely known or determinable. They should be placed in the accounts at cost, and the cost of each should be amortized over a period not in excess of its legal life. In most cases they are written off over a shorter period than their legal life because of the uncertainty of their continuing value.

The assets listed in the third group, such as goodwill, secret formulas, and organization expense, do not represent rights legally protected for specified periods of time. In reality they merely represent the hopes or expectations of the management, unprotected by law and uncertain of realization. It is not usually considered contrary to sound accounting theory if they are allowed to remain in the accounts at their original costs, nor does there seem to be much objection if they are omitted entirely. The conservative accounting practice is to write off organization expense as soon as possible through charges to surplus. As a matter of fact, organization expense is more frequently classified and shown on the balance-sheet as a deferred charge than as an intangible asset. Secret formulas should be recorded at their cost of development, or their purchased cost, and should be written off as rapidly as the nature of the formulas and their resulting products might indicate to be conservative.

Among all the intangible assets it seems that goodwill is less understood, more loosely defined, and accorded a wider variety of accounting treatments than all the other intangibles combined. It is admittedly difficult to define and evaluate, but its wide variety of accounting treatments is difficult to understand unless we assume that we have not accepted a uniform definition. Or perhaps we *have* accepted and used a uniform definition, but one which is so *general* as to permit *any* desired treatment of the term.

We shall not attempt to re-define goodwill here, but we hope that an attempt will be made to do so later. Nor shall we consider the many ways in which it is treated in the accounts and statements except in those cases which indicate a need for a better definition and understanding of the term. In the June, 1938, issue of the *Accounting Review,* in an article entitled "Goodwill on Financial Statements," by George T. Walker, the author listed the following intangible items which he found in an analysis of fifty published financial statements: brands, patents, licenses, leaseholds, copyrights, goodwill, trademarks, formulae, processes, franchises, royalty interest, trade names, contracts, and organization costs. This doesn't exhaust the list of possible intangible assets by any means, but the most remarkable thing he found was that on thirty-seven out of the fifty balance-sheets examined, goodwill was included in various combinations of these other terms and was shown under one title in a single combined amount. I insist that this combined treatment of so many items, many of which are almost wholly unrelated to each other, is vague, confusing, and misleading, and certainly the variety of treatments indicates a deplorable lack of uniformity. If the term were more clearly defined and carefully interpreted, it is difficult to envision such treatment of it. Such a definition should indicate to the careful and conscientious accountant when goodwill should be shown on a balance-sheet, where it should appear, and at what value. It should lead to more uniformity in our decisions as to why, when, and how the amount of goodwill might be reduced or removed from the balance-sheet. Our present uses of the term "goodwill" are so varied, vague, inconsistent, and misleading that our professional integrity and the accuracy of our work may frequently be open to question by the management and stockholders of corporations and by the general public, who are coming to rely more and more upon information revealed, or shall we say unrevealed, in published financial statements. I hope that sometime some writer (or speaker) will have the courage to bring out into the open for discussion the question as to whether goodwill should really be defined and classified as an asset, separate and apart from the other assets of a going concern, without which there would be no goodwill value.

Contingent Liabilities

The items usually included under the term "contingent liabilities" have certain characteristics common to those included under the caption, "intangible assets." As representing an all-inclusive group, the term "contingent liabilities" is difficult to define, the amount and certainty of each item within the group may be difficult to determine, and there seems to be a great degree of uncertainty in the minds of accountants as to the proper accounting treatment of the items in the group, and of the group as a whole. Briefly stated, contingent liabilities are those which may or may not materialize into actual liabilities at some future date. They cover a very wide range, from definite certainties to the most remote possibilities. The success or failure of every business depends to some extent upon many unforeseen and unpredictable conditions and circumstances. All such conditions and circumstances of an unfavorable nature which may arise in the future path of a business are contingent liabilities. The extent to which these contingent liabilities are anticipated and properly recognized by the management of a company usually indicates the degree of conservatism of that management.

Since all business concerns are faced with certain contingencies, we sometimes view with suspicion a financial statement which omits any mention of or provision for certain types of contingent liabilities which we are reasonably sure exist. Such a statement is misleading, but we are misled even more if we fail to note the absence of contingent liabilities from the statement. Their presence on the statement at least serves notice of their existence. On the other hand, if we examine a financial statement upon which every possible contingent liability is mentioned or provided for by reserves, we accuse the management or their accountants of being ultra-conservative and point immediately to a probable understatement of surplus. Somewhere between these two extremes lies the proper treatment of contingent liabilities.

The purposes of my discussion of contingent liabilities are to emphasize the importance of their recognition, to point to the lack of uniformity in their accounting treatment, and to stimulate interest in a further study of this term in an effort to formulate a clearer definition of the term and a proper classification of the items covered by it.

The definition and treatment of an item as a contingent liability should be determined by the nature of the contingency. Any casual analysis of published financial statements will reveal items incorrectly classified as contingent liabilities. It will also reveal a lack of uniformity in the accounting treatment of items which have been correctly recognized as contingent liabilities. Items frequently appearing as contingent liabilities in various positions on published statements may be classified roughly as follows, according to their nature:

1. Those the amounts of which are known, but which are not certain to become actual liabilities. Examples: discounted notes receivable; endorsements on notes payable.
2. Those which are certain to become liabilities, but the amounts cannot be determined accurately in advance. Examples: claims for admitted damages, the amount of which may be determined later by court action or arbitration; taxes.
3. Those in which neither the certainty nor the amount of the liability can be determined in advance. Examples: claims for damages not admitted; probable losses in inventories due to declining prices.
4. Balances remaining in the accounts from provisions made in previous years for contingencies which have now ceased to exist. For example, contingent liabilities on contracts, subsequently performed without an actual liability resulting.
5. Those of more or less arbitrary amounts set up for unspecified contingencies.

No accountant should question the wisdom of properly providing for reasonable contingencies, but it seems unwise and unnecessary to define and classify as a contingent liability any item which might well be treated as an actual liability. If the amount of such an item is known, or a reasonable estimate of its amount can be determined upon the basis of experience, and if it is reasonably certain to become an actual liability, it should be shown as an estimated liability in the liability section of the balance-sheet and not as a contingent liability. Frequently such amounts are indicated as contingent liabilities and shown in the liability section of the balance-sheet. It indicates an error in the use of terminology rather than an error in the classification of the item.

I think we should discourage the use of the term "contingent liability" to indicate a subdivision of the surplus account made solely for the unadmitted purpose of reducing the amount of surplus available for dividends. Obviously, after a contingency for which provision has been made ceases to exist, the amount of such provision, or its remaining balance, should be closed into surplus.

I think a definition of contingent liabilities should indicate some sort of limit to the length of a future period of time in which contingencies should be anticipated and provided for. Ordinarily, I believe it is sufficient to anticipate and provide for only those contingencies which may materialize in the succeeding period of one or two years.

In conclusion, I should like to repeat

that my purpose in discussing the terms "intangible assets" and "contingent liabilities" has been to emphasize the urgent need of a more careful definition and use of these terms and a more thoughtful analysis and classification of the individual items encompassed by each, so that our accounts and financial statements will reveal, rather than conceal, all pertinent information, so that they will cease to reflect our own vague uncertainty and our woeful lack of uniformity in the application of sound principles to the practice of our profession.

IV

Industrial Accounting

Chairman: HARRY E. HOWELL *September 18, 1941*

Introduction

BY HARRY E. HOWELL, PROVIDENCE, R. I.
Member, American Institute of Accountants

WITH an increasing part of the Nation's industrial facilities turned toward defense production and away from nondefense production, the impact of government rules and regulations upon all phases of their accounting set-up will be very definite and extensive. For those who have direct government contracts, a complete set of accounting problems arises because the definitions of cost used in the government contract do not always conform with accepted practice.

The difficulty of preparing cost estimates under conditions which produce scarcity of material, substitutes of material, inefficient labor, training expense and operations quite often beyond the normal capacity rate, call for extensions of cost-accounting theory that necessitate careful audit and checking to avoid serious miscalculations. Likewise, government contracts create marked change in the procedure or methods in order to conform to their auditing requirements. Usually these same auditing requirements are of major assistance to the independent auditor in carrying out his assignments, but he most certainly will be interested where the procedures have not been changed with the result that payments of government contracts might be held up and delayed.

While T.D. 5000 and subsequent interpretations seem to set forth clearly what shall be allowable cost, there is ample room for discussion and difference of opinion, and the fact that there is no present uniformity in the accounting policies of the various government agencies making the matter more difficult. The independent accountant will have a responsibility for seeing that the government contract which may be the bulk of the client's business, has been negotiated and is being handled in such a way that no contingent loss or tie up of funds is likely to result.

Ordinarily cost-accounting procedures consistently carried along do not impose any unusual problems upon the independent accountants, but operation under government contracts creates new problems, and the way in which the unusual cost and variances are handled may have an extremely important bearing on the financial showing at any given time. Possibly price control will simplify the problems of material prices but the added cost of overtime labor, the premiums paid night-shift workers, and the cost of training programs all create excess costs, the treatment of which requires careful study.

In addition, the greatly increased rate of activity induced by the defense program has created a serious problem of deciding whether normal capacity figures for absorbing overhead should be adjusted to give some recognition to the current industry production rate. If this is done the effect upon the cost used in present nondefense products must not be overlooked. Likewise, the question of whether the overabsorbed burden credit should be allocated to the government contracts or spread over all of the products will arise.

A concern which takes a government contract and lays out money to expand its plant and buy new equipment wants to recover the cost of that expansion from defense business and expects to do it tax free by deducting from income received on government contracts a portion of its expense and cost. Congress recognized this and amended the tax laws, and the taxpayer can deduct 20 per cent of the cost of a defense facility from defense income in each year and recover the entire cost tax free in five years or the lesser period of the emergency. However, like any other dispensation of Congress it is hedged in with many specific rules and technicalities which must be understood if the benefit of these rules is to be obtained.

Where existing equipment is used there is still a possibility of making some recovery of the cost of the defense project by the use of accelerated depreciation and the Bureau of Internal Revenue recognized that machinery may depreciate faster if used a greater number of hours today or forced to operate at a higher speed or used under abnormal strains or special uses. The proving of accelerated depreciation so as to get it allowed by the Bureau is, however, a difficult procedure.

In addition to private investment with government reimbursement which is the situation described above, other forms of financing such as private investment without government financing and outright government financing and ownership are being used, and some aspects of the situations arising under the various forms will be discussed.

Probably a matter of the most serious consequence to industry and one having the most drastic effect on the profit situation and requiring the most careful handling of cost information will be the extent to which price-control legislation will be exercised. We have seen that the President's executive order directing the Federal Reserve Bank to control installment selling will in a short time drastically curtail certain types of sales and consumer habits. Under the price-fixing bill there is authority to fix the prices of industry commodities, of groups of commodities, or to establish a general price ceiling over all commodities. It appears that prices in effect July 29, 1941, may be used as an indication of what would be a fair price and that in the event of fluctuations therefrom O.P.A.C.S. might require cost data justifying the change in ceiling price.

There may be an appeal from price ceiling orders, but it will require real substantiation, ability to prove costs to show that the price ceiling leaves no profit, and factual evidence which can only be produced from the figures.

Certainly the cost records should reveal the extent to which unusual costs should be recognized in setting price ceilings and the careful treatment of these items which have been discussed not only for the purposes of sound cost and financial accounting but for this further purpose should engage the attention of both the industrial accountant and the investigation of the independent accounting.

It is quite apparent that the unusual conditions under which business is operating is going to present unusual problems for the industrial accountant and requires the independent accountant to range far afield in his investigations of the type of business the company is doing, the way it is handling its costs, pricing its inventories, and pricing and billing its government contracts in order to assure himself that there are no latent contingencies which might drastically affect the profits or the financial stability of the enterprise. Difficult as these problems are they cannot be ignored or handled on the basis that somehow or other we can "muddle through."

It is fortunate that the responsibilities of the independent accountant and the industrial accountant can be solved at one and the same time by a thorough understanding of the problem and an adjustment in procedures, and it is for this reason that this session is devoted to a mutual approach to the subject.

Some Accounting Problems Arising under Defense Contracts

BY J. W. MCEACHREN, DETROIT, MICH.

Member, American Institute of Accountants

DURING the first world war, cost-plus contracts were extensively used, but the payment by the government to the contractor of a profit which increased in direct proportion to increased cost was subjected to some criticism. However, no better means has apparently been worked out of protecting the contractor against a substantial loss and, at the same time, protecting the government against an excessive price than the use of some form of a cost-plus contract in cases where the contractor has not had experience in making the product. Under the current form of cost-plus contract the contractor is reimbursed for actual costs and is paid a fee fixed in amount at the time the contract is signed. Generally speaking, the fee does not increase with increased costs and the contractor is not penalized by a lower fee if costs decrease.

The contractor is reimbursed for actual expenditures as frequently as may be requested after audit by representatives of the government. Ninety per cent of the fixed fee becomes due in proportion to the progress of the work and the remainder is payable upon completion. Payments on the fee are made regardless of whether any of the product is completed and shipped. Usually the percentage of completion is determined by accepting as a basis the ratio of expenditures to date to the total estimated cost of the contract.

The amount of the fixed fee is set forth in the contract and is determined by applying a certain percentage to the estimated cost. The percentage is limited to a maximum of 7 per cent, although most contracts have been let at a lower figure. The fixed fee does not change because of ordinary variations between the actual and estimated costs, but if there is any substantial change subsequently made in the character of the work, either through a change in the quantity of product to be delivered, a major change in the specifications or in the method of processing, an equitable adjustment is to be made in the amount of the fee.

Actual costs for which reimbursement is to be made currently to the contractor are to be determined in accordance with Treasury Decision 5000 which may be amplified or amended by specific provisions in the contract itself.

The contract provides that "the contracting officer and his representatives shall have access to all accounting records applicable to the contract." Also, "the method of accounting used by the contractor shall be subject to the approval of the contracting officer, but no material change will be made in the contractor's method if it conforms to good accounting practice, and the costs are readily ascertainable therefrom." The contractor is required to keep the cost records intact for three years and to obtain the permission of the government before destroying the files.

Problems in Preparing the Cost Estimate

It is a fair assumption that the product under consideration is one that the contractor has not previously made or is quite dissimilar from anything heretofore manufactured, and involves a relatively large sum of money. Unless one or more of these conditions were present, a cost-plus-a-fixed-fee contract form would probably not be used.

The estimate of the cost of the contract should be carefully prepared, since the amount of the fee to be received by the contractor is based directly thereon. Any item of cost not provided for in the estimate is not thereby disallowed in reimbursement, but the contractor's fee is correspondingly lower in relation to the final cost of the contract.

Material costs usually present the least serious problems, although complete and final engineering specifications are not always available at the time the estimate is made. One of the problems in estimating material costs is the factor of cutting waste or offal since the sheet sizes from which parts may be produced are frequently not definitely known. It may be necessary to add a flat overall percentage to material costs for this factor.

Possibly the most difficult item to estimate is labor cost. The contractor may be forced to hire and train an entirely new direct-labor force or to transfer labor from existing divisions into a new plant to work on unfamiliar products and new processes. At the very least, there is the problem of getting production of a relatively new product flowing smoothly through an existing production organization. Consideration should be given to the possible necessity of operating on at least a 48-hour week with allowance for the overtime rate which this would involve.

Then there is the factor of training which may be done in a separate school created for that purpose. This may involve payment of trainees and will require expense for supervision, supplies, and so forth. Some proportion of the trainees will not complete the course and others will not prove acceptable.

After school training, there will be a further training period in the production departments under the direction of skilled workmen. This will involve payments to trainees and the wages of the workmen doing the training.

The lack of experience of trainees from the school and old employees transferred from other divisions will result in very excessive unit-labor costs in the early stages of production. Assuming that unit-labor costs have been estimated on a normal basis, it will be necessary to add to these figures a substantial amount for the "starting load." In the first month of operation, for illustration, labor may average only a 30 per cent performance. In other words, unit-labor costs may be more than three times the normal. In the next month, the performance may rise to 50 per cent and so on until approximately 100 per cent performance is attained.

The inexperience of labor will also substantially increase the production spoilage, and provision should be made in the estimate for excessive scrap costs in the early months of production.

Particularly on airplane parts, the requirements for precision and finish are relatively high and inspection is severe. This situation should be kept constantly in mind in estimating the normal labor and scrap costs and the starting load.

The problem of estimating factory burden costs is aggravated by probable delays in getting production under way because of lack of complete equipment, changes in specifications of the product, shortage of material, and so forth. A recent report by the National Association of Manufacturers based on replies to a questionnaire from defense contractors shows that 75 per cent of the contractors were experiencing some delay in getting material and 55 per cent were delayed by lack of machine tools. These contingencies should be kept in mind as background in preparing the cost estimate. Fixed burden such as supervisory salaries, insurance, taxes, and depreciation will accrue in advance of the actual starting of production. It will be necessary to bring in a substantial part of the supervisory staff in advance for the purpose of their own training in addition to the preliminary work they will do in organizing for production. It may be desirable to send a number of supervisors to plants where the product to be made by the contractor is already being manufactured by an experienced producer.

Problems Created by Government Auditing Requirements

In addition to the audit made by the branch of the service involved, all of these cost-plus-a-fixed-fee contracts are subject to audit by the comptroller general's office. Since the comptroller general's audit is made in Washington, it is necessary to furnish rather complete original documents for his files there. These include an acknowledged copy of the purchase order, copies of purchase-order change notices, purchase invoices, transportation bills, traveling-expense reports, payrolls, list of requisitions, etc. He is now receiving literally tons of paper and the volume will increase tremendously in the very near future. The comptroller general will not accept anything but original documents or copies which are certified to be true and correct copies of the originals.

If invoices are not covered by purchase orders, it is necessary to submit a certificate by the contractor to the effect that the expense was necessary in connection with the performance of the contract, giving a reasonable amount of detailed information. This procedure applies particularly to bills for professional services of various kinds, and other items for which purchase orders are not customarily issued. If purchase orders refer to any underlying agreements or correspondence which affect the terms of the transaction, the comptroller general is also interested in having true copies of the original documents, or the original documents themselves, if available.

The requirements of the comptroller general's office are apparently being modified to some extent currently to make them more adaptable to the tremendous volume of contracts which will come under his review. For illustration, I understand that petty cash vouchers not exceeding $10 in amount will be accepted if certified as correct by a responsible designated employee of the contractor and if an adequate description of the item is shown. Previously, invoice copies and purchase-order copies would be required if the disbursement covered a purchase of supplies.

All of the foregoing regulations create a considerable accounting problem for the contractor. Many companies have not heretofore followed the practice of obtaining acknowledgments of purchase orders and the question arises as to whether all purchase-order change notices must also be acknowledged. Usually it is impracticable to obtain extra copies of transportation bills and it becomes necessary to make photostatic copies. Traveling expense reports must also generally be photostated. Currently there is not available a clear-cut definition as to just what is an original and what is a copy. In general, three copies of all documents are required for various government auditing purposes although additional copies of some items, such as purchase orders, may be necessary.

Purchase invoices for materials and supplies chargeable directly to the contract cannot be passed for reimbursement by the government auditors until there is available a proper receiving report approved by a government inspector. Frequently the volume of work prevents getting this approval until the discount date is past, but in most cases the material is obtained from a reliable source so that the contractor can risk paying the invoice before the inspector's approval. Receipted invoices are not being required in connection with all supply contracts but the government auditors must have available some evidence of payment. The contractor is to be reimbursed only for items of cost which have actually been paid for by him.

In plants handling other work in addition to a cost-plus contract, it will be necessary to allocate salaries of supervisory employees, for illustration, to the cost-plus contract. In this case, it is necessary to have the employee concerned keep a time record prepared daily showing the number of hours applicable to the contract, and preferably some description of the work performed.

Usually it is not possible to have the invoices, payrolls, etc., audited by the government auditor for reimbursement before they are entered on the company's own records. There is, therefore, a considerable amount of expenditures in the process of being audited by government representatives. This makes it necessary to have a constant reconcilement between the costs entered on the company's books and the cost passed by the government auditors for reimbursement.

Title to the raw material, in process and finished inventories passes to the government as soon as reimbursement is made in whole or in part. The contractor has a definite responsibility in accounting for the materials on hand. This makes it necessary physically to segregate materials for which reimbursement has been received and to carry a complete stores record in quantities and dollars on raw materials, and to issue materials on requisition. At this point, as far as I know, no regulations have been set down for carrying any detailed records on work in process. Control over finished goods does not represent a serious problem since they do not usually accumulate in any quantity in the contractor's plant.

Once the title to the material has passed to the government, it cannot be sold by the contractor without specific permission. In cases where the contractor sends out raw material (for which he has been reimbursed) to subcontractors for machining, it has been ruled that he must get back all the scrap including the borings and turnings. The difficult problem of keeping borings and turnings segregated in the subcontractor's plant is presented and there is always some factor of shrinkage involved. There will be a difference between the gross weight of the material sent out and the total weight of good pieces and scrap and turnings sent back. What percentage can the contractor allow as a reasonable shrinkage?

In plants which are so-called "mixed plants"—in other words, in addition to cost-plus contracts there is a fixed price contract or commercial work flowing through the same departments—all material may not be bought for specific contracts. In this case, the contractor owns the material until it is actually used on the cost-plus contract and he is reimbursed on the basis of requisitions issued from stores.

If special dies, jigs, and fixtures are made and charged to the contract, it may be necessary to carry a record to account for each individual tool. Each tool should be adequately identified as to the contract to which it applies and the fact that it is the property of the government.

A neat problem is presented when an additional cost-plus contract is taken on in a plant operating exclusively on a cost-plus-a-fixed-fee contract. Reimbursement has already been made for materials and supplies bought, organization and training expense, and possibly rearrangement of the plant. All of this has been charged against the previously existing contract but benefits the new contract being started. Should a complete inventory be taken when the new contract starts and an equitable adjustment made? How should future purchases of materials, supplies, and services be allocated to the two contracts? How can cutting waste be allocated if similar materials are used?

While the government is primarily interested in the over-all cost of the contract, information as to unit costs is welcomed and is essential for the contractor in most cases. Many cost-plus-a-fixed-fee contracts contain a clause that as soon as feasible negotiations will be entered into to place it on a fixed price basis and the price established will be retroactive to the start of the contract. Obviously, dependable information as to unit costs is essential in setting the fixed price. Costing for this purpose and for current control of costs can be carried on as a supplemental accounting operation but should be regarded as statistical and not formally entered on the general books.

Reimbursement for Costs

As previously mentioned, invoices for materials and supplies must be supported by receiving reports approved by a government inspector. All invoices, payrolls and journalized costs must be approved by the resident government auditor who prepares public voucher form 1034. This voucher must be approved by the contracting officer and then is forwarded to a government finance officer who draws a check to the contractor if the voucher is in order. The original of the voucher and the supporting data go to the comptroller general's office in Washington for his audit.

Problems of Interpretation of T. D. 5000

Treasury Decision 5000 was issued in connection with the Vinson-Trammell act to set up a definition of costs for the purpose of enforcing that act. While the profit limitation features of the act have been suspended, the cost formula has been adopted as a convenience in defining costs under cost-plus-a-fixed-fee contracts. Generally speaking, T. D. 5000 impresses the accountant as being a reasonably fair definition of cost; however, it specifically excludes a number of items which are generally accepted as being a part of cost, such as certain types of bonuses to officers, entertainment expense, certain donations, extraordinary expenses due to strikes or lockouts, and other items with which you are no doubt familiar. Any provisions inserted in the contract itself in relation to costs may amplify or amend the language of T. D. 5000. The standard form of cost-plus contract contains the following provision: "For purposes of determining the amount payable under this contract, allowable items of cost will be determined by the contracting officer in accordance with regulations promulgated by the Treasury Department in T. D. 5000." There will be some difference of opinion as to what items are allowable and what are not allowable.

For illustration, some of the branches of the services have taken the position that a reasonable allowance for traveling expenses other than transportation is $6.00 per day for employees and $10 per day for executives. There can easily be a difference of opinion on this point. There is also some indication of a tendency to establish a rather low maximum for salaries and bonuses. These items are being questioned aside from any specific provisions of T. D. 5000, and there is an indication that the government auditors and the contracting officers are going to challenge all expenses as to their general reasonableness aside from the specific language of the cost formula.

There has been a fear on the part of contractors that certain types of costs such as scrap loss due to engineering errors or mistakes by the workmen might be disallowed. Such errors occur in the normal course of business and are likely to be more prevalent with a new product and a relatively inexperienced organization. There is some evidence that the comptroller general will take a reasonable attitude in this regard. In a recent decision he has approved payment of an item of cost arising from an error made apparently in good faith by a purchasing agent in ordering material which could not be used.

T. D. 5000 provides that the allowable expenses of administration shall ordinarily be allocated or distributed to the cost of performing a contract on the basis of the proportionate manufacturing cost.

It also states that the allowable bidding and general selling expenses and general servicing expenses shall ordinarily be allocated or distributed to the cost of performing a contract either on the basis of proportionate sales or the proportionate manufacturing cost. The bidding and general selling expenses allowable are those which "by reference to the pertinent facts and circumstances reasonably constitute a part of the cost of performing a contract or subcontract." No mention is made of advertising expense. It is not included in the list of items specifically disallowable. If the product being made under a cost-plus contract is of the same general type as the company's regular products, there would appear to be some basis for allocating selling and advertising costs to the contract. Presumably these costs are necessary in building up the contractor's regular business which in turn makes it possible for him to manufacture in volume and thereby reduce costs on the government work as well as his regular commercial line.

Both industry and government are facing a huge task in the accounting and auditing problems created by cost-plus contracts. One is impressed with the great amount of care which is now taken in checking contract costs. The audit procedures being carried out by the various procurement branches of the Army and Navy are reviewed as to adequacy and performance by individual accountants and committees who are making a personal sacrifice to carry on this work. In addition, we have the review of all disbursements by the comptroller general's office.

The procedures involved in accounting for costs under cost-plus-a-fixed-fee contracts may at first appear unnecessarily complex and some modifications are being made currently. However, the nature of the arrangement and the impression still remaining, whether justified or not, that such contracts encouraged high costs in the last war, make it essential to have a thorough check and very complete supporting records. Both the contractor and the government benefit thereby.

Cost Problems in Connection with Price Control

BY HERBERT F. TAGGART, WASHINGTON, D. C.

With Office of Price Administration, Washington, D. C.

THE title of this talk could well have been "The Lesser of Two Evils." When the emergency price-control bill was introduced into Congress a few weeks ago the *New York Times* made the following comment: "President Roosevelt's proposal for virtually over-all control of commodity prices was received with reluctant approval by many businessmen yesterday, even though they are traditionally opposed to any extensions of government controls over business . . . the general view was that price control is the lesser of two potential evils . . . the other being dangerous inflation." Having been brought up in a very old-fashioned school of economic thought myself, I can't help having sympathy with the businessmen. I was taught that the price mechanism is the great regulator of our system of free enterprise, and that it works best when left alone. "Don't monkey with the thermostat," was a favorite saying of "Old Freddie," as we used to call our professor of economics.

In common with the businessmen I am a thorough believer in the desirability of letting price perform its normal function—to equate demand and supply. In the long run, administered prices, whether administered by the combined action of businessmen or by a department of the government, are certain to be less satisfactory from a social point of view than free prices. They will result in lower production, less satisfactory distribution and a lower standard of living than will prices freely determined in the market place.

"Old Freddie," however, would not have been guilty of taking the attitude that the price mechanism should be left to itself when the country is at war or in a state bordering on war—when the economic forces which normally govern demand and supply and price are all topsy-turvy and can no longer be depended on to produce the greatest good for the greatest number. What many opponents of price regulation forget is that we are essentially in a war economy and that the very existence of the national institutions which we prize so highly depends on all-out effort to furnish first the goods and services required for defense and, secondly, to maintain as far as possible those goods and services and conditions which are necessary for civilian comfort, health and morale. To this end all ordinary considerations must be subordinated.

In view of the concentration of this program on problems of peculiar interest to the industrial accountant, I shall not enter into a general discussion of the policies and problems of the Office of Price Administration. In connection with industrial accounting problems, however, two well established attitudes of O.P.A. with regard to causes or excuses for price increases are worthy of comment. One is that, although we recognize the importance of actually sustained increases in costs, we look very unsympathetically at the notion that prices must be increased now to take care of vaguely defined cost increases which are expected at some indefinite time in the future. We fully appreciate the forward seller's difficulties, but both the common practice of quoting no prices at all and that of adding a substantial cushion to cover unforeseen events are direct roads to the inflation and spiralling of prices which it is our job to prevent. Both practices are an open invitation to step in with a price schedule.

Another argument with which we are frequently confronted is that the particular concern or particular industry has suffered heavy losses over past years and must now be allowed to make these up. A variation of this is the argument that the industry in question is one in which seven lean years follow every fat year. This—the year 1941—is the proverbial fat year, and we must let industry put on a little fat to take care of the lean years ahead. There are several answers. One is that, after all, this fat year is a result of the defense program. It is not a natural, but an artificial business boom. The principle has been enunciated that we are to have no wartime millionaires. The putting on of fat, therefore, must be in strict moderation. Another answer is that already the Congress has made the putting on of fat a pretty difficult operation, and that the surest way of creating sentiment for making it impossible is the attempt to obtain abnormal profits by excessive prices.

My particular responsibility in the O.P.A. is the cost aspects of price control. The cost accounting staff of O.P.A., which started out with one man in June of 1940, now numbers approximately thirty, with more being added daily. Most of the time of these people is being spent on the problems of individual firms which for one reason or another find themselves in some special position with respect to price agreements or price schedules. Industry-wide surveys have, for the most part, been conducted for us by the accounting staffs of the Tariff Commission and the Federal Trade Commission. Many of you will recall that accountants employed by the Federal Trade Commission carried on most of the cost studies in connection with price control during World War I. For this purpose they employed a staff of some 300 accountants.

The cost accounting or, more precisely, cost-analysis work in connection with price control may be roughly divided into three categories. The first consists of cost studies made in contemplation of either formal price schedules or voluntary ceiling agreements. No such arrangement is ever entered into without giving consideration to the cost factors involved, although nothing like an exhaustive cost study is undertaken at this stage.

The second variety of cost study takes place after the schedule or agreement has been established. Its purpose is to discover how the prices are working and to prepare the ground for revisions or modifications. Such surveys may be industry-wide in scope, but they are ordinarily carried on by means of sampling. Concerns are chosen for study with an eye to obtaining representation as to size, location, variety of products, and methods of operation. Based on such studies are decisions as to the adequacy of the chosen prices to yield a fair return, the reasonableness of differentials based on grades of product, quantities of sales and other factors, and the desirability or necessity for raising or lowering the established levels of prices.

The third kind of cost study deals with the problems of individual enterprises. In its most complete form it involves a thorough examination of costs, sales, markets, operating problems and policies, and financial history and position. The purpose is to discover whether the particular concern requires relief or other special treatment in connection with established price schedules or announced price policies. Usually such studies result in some sort of adjustment for the particular concern, but they occasionally show the need for changes in the price schedules or price policies.

These individual studies have, up to the present, taken a very large portion of the time of the accounting staff of O.P.A. They unquestionably constitute the most interesting part of our work, since they comprehend the whole range of business analysis, and not merely a study of accounting data.

Such studies originate most frequently after an official price schedule has been promulgated. Price schedules necessarily apply to everyone in an industry on a uniform basis. However, it is recognized that such universal rules, if inflexibly applied, may result in serious hardships to individual concerns. Hence an invitation is always extended to present such hardship cases for special consideration. Figures and other data are examined; legal, marketing and engineering considerations are given due weight; a report is written, accompanied by a recommendation to the Administrator that the particular type and extent of relief desired should or should not be granted. Such relief has already been extended in a considerable number of cases.

At this point I should like to present a number of problems confronted by the O.P.A. in which cost-accounting considerations are involved. Together with the problems, I should like to offer tentative answers and my reasons for these answers. These conclusions are solely my own: they do not represent the official attitude of O.P.A. and they are not in any sense conclusive. They are still open to argument and, in particular cases at least, to exception.

Price Ceilings

The first problem concerns the procedure for establishing price ceilings. Should this be done only after an exhaustive cost study of the industry or product in question? This procedure has been seriously proposed by industry representatives. My tentative answer is decidedly no. The reasons for this answer include first, the enormous delay which, all by itself, would make price actions based on such studies hopelessly ineffective. Months would elapse while questionnaires were prepared, sent out, returned, checked, and tabulated or while field investigations were organized, carried out, and reported upon. Meanwhile prices would be skyrocketing and the economy would be suffering all the aches and pains which O.P.A. is set up to prevent. All this quite regardless of the tremendous technical difficulties of obtaining costs which are sufficiently specific, authentic and up-to-date to satisfy the economic and legal requirements. Also quite regardless of the fact that prices are only in part based on costs and that in many instances the cost studies would be practically disregarded in the final reckoning.

The alternative to a cost basis for price schedules is, of course, the recent price history of the industry, taken together with the profit-and-loss picture and other pertinent economic data. As I have previously remarked, cost considerations should by no means be entirely neglected, but they must have a secondary rôle at this stage of the price-control mechanism.

Another problem somewhat related to the first is concerned with the establishment of price relationships within an industry—relationships between and among qualities, grades, constructions, and other classifications of products. Should such relationships and differentials be set on the basis of relative costs, or should the price history of the given industry be governing? Here again the tentative answer must favor price history as a guide rather than costs. It has been seriously proposed by certain industries that O.P.A. should take a hand in correcting what are claimed to be past mistakes of the industry in its pricing policies. We should take this opportunity to rectify inequities and to put prices on a scientific basis. To my mind any such action on our part would be extremely foolish. Costs, as has been said before, are by no means the only determinants of price. Other factors affecting supply and demand are at least of equal importance, and it would hardly be safe to assume that a price schedule based solely on costs, no matter how scientifically arrived at, would be a practical success or would really give an industry any permanent satisfaction.

To this conclusion there must perhaps be one modification. As time goes on, and experience under price schedules gathers weight, it may be found that prices have been established too low on some products and too high on others. Where productive machinery and personnel can be shifted from one line to another, the tendency will be to concentrate on the overpriced lines and to neglect those whose prices have been put too low. Presumably the normal corrective for a condition of this sort will be to study the cost picture and to adjust prices in the direction of greater conformity to relative costs. This conclusion is subject to some doubt in particular cases, however, and it by no means follows that we should follow the cost line in the first instance.

A further question, to which the answer is scarcely tentative, relates to the type of data on which decisions as to relief from price schedules and similar actions may be taken. Can we depend solely on the cost accountant, and base decisions on cost sheets, cost schedules, and other computations of costs? We are continually asked to do so. Businessmen and their accountants bring in cost data showing that their costs have increased by a given amount or that they are such an amount higher than the ceiling price. No matter how carefully such data are prepared, though, and no matter how adequately presented, we find it necessary to ask for the complete picture —the profit-and-loss and financial situation as well.

Cost compilations never tell the whole story. This is well illustrated by an experience which one of my staff recently had with a small steel company which had asked for relief from price schedule No. 6. The company had made a pretty good presentation of its case. Its wages had gone up, and supplies and other items were costing more than formerly. The accountant was impressed with the justice of the claim, although he was not quite convinced that the relief required was quite as great as that desired. Negotiations dragged a bit, as they sometimes do, and the June earnings statement came out. The president of the company came in with a very red face. The company had earned more in June than in any month of its history! The request for relief was withdrawn.

It can easily be imagined that the detailed problems of the relation of costs to prices which have already been encountered would fill a good-sized book. One of the most fascinating parts of our job lies in the fact that we must look into the future—we must try to see how a certain set of circumstances and a certain course of action may be expected to affect both the financial status of our "clients" and the supplies of the commodities which we want them to produce. A highly developed imagination is an essential qualification for employment in our accounting division.

Problem of Inflation

I always like to spend a few minutes of each talk I give speculating on what are our chances of doing a respectable job of controlling the inflationary spiral. No one supposes that we can do a perfect job. The problems are too complex and the forces at work too powerful. There is much evidence already, however, that the price stabilization division was not established in May, 1940, entirely in vain.

Our greatest source of strength lies in the fact that the long-run self-interest of every element of society has a huge stake in our success. The farmer will not profit by higher prices for his products if the prices of everything he buys go up correspondingly. The worker's economic status is not improved unless his real wages are maintained. The businessman remembers with a shudder the inventory writedowns of 1920 and 1921. Our greatest weakness lies in the fact that many of these people have the idea that somehow they will be able to get their prices up while others stay down—the idea that somehow they will be able to steal a march on the other fellow. Price control receives their whole-hearted support—when applied to their neighbor's prices!

In spite of obvious difficulties and complexities, in spite of many disappointments already experienced, I continue to be moderately optimistic. We have studied the experience of other nations and of the last war assiduously. We think we know where some of the mistakes were made and how to avoid them. We have made a much earlier start than did our predecessors in 1917, and we already have a veteran organization. Accounting and statistical data are much more complete, reliable and available than they have ever been before. Other powerful government agencies are solidly back of the fight against inflation and are in a position to supplement our efforts by actions tending to cut down demand or to increase supply. With all these things in our favor, we at least have a fighting chance.

Effect on Financial Statements of Standard Cost Procedures and Audit Problems Arising Therefrom

BY WILLIAM F. MARSH, PITTSBURGH, PA.
Member, American Institute of Accountants

I PROPOSE to discuss first the standard cost procedures with respect to materials, labor, and overhead, and their effect on financial statements and related audit problems. Then I shall outline some problems which arise as the result of present conditions and, finally, point out a number of problems which arise from accounting requirements under defense contracts, particularly cost-plus-a-fixed-fee supply contracts.

This discussion of procedures and accounting and auditing problems will relate principally to the type of standard costs usually referred to as "current" or "ideal" standard costs. Under such a standard cost plan, it will be recalled, standards are considered to be the justifiable costs. Consequently the accounting procedures are so designed that variations from standards are segregated and diverted to variation accounts which are appropriately disposed of, and costs of manufacture then pass through work-in-process, inventory, and cost-of-sales accounts at standards.

Under the alternative or so-called "basic" standard cost plan, the standard costs do not purport to indicate what products should cost, except possibly at the time of the original standard cost installation. Having once been established they become not a criterion of current costs, but are used as a yardstick for measuring all future activities. Under the "basic" plan, inventories of work-in-process and finished stock are carried in the accounts at actual cost, and hence no adjustment of these accounts is made for deviations from standards, and standard costs do not appear in the financial statements.

It will be observed as this discussion proceeds that the methods used for adjusting current standard costs for financial statement purposes are similar to the procedures where basic standard cost systems are in use. This also applies to the solution of some of the problems arising in connection with accounting for defense contracts.

MATERIAL VARIANCES

In considering the treatment of material variances and their effect on the material component of inventory amounts, two situations should be considered. The first is that in which purchase-price variances from standards are taken up in the accounts at the time the raw material is received and placed in stock, or where the raw materials are charged into stores at actual cost and variances are taken into account at the point of movement of the material into work-in-process. In the latter circumstance, the only inventory amounts which are affected are the material components of work-in-process and finished goods. In the first circumstance the variances also affect the valuation of raw materials. In either, since all purchase-price variations are taken up at the time purchased material is received or when it moves into work-in-process, all variances reported in the cost of manufacturing operations are the result of the utilization of material as opposed to price variations.

The second situation is that in which raw materials or purchased materials are placed in stock and also charged into work-in-process at average actual cost. Where this is the case, material variances may involve both price and usage variations. If the variation occurring in the work-in-process account includes both price and usage, it is necessary to provide procedures for their separate identification in order that each may receive appropriate treatment in the financial statements. A credit variance, indicating that actual costs are lower than the standards, generally should be the basis for an adjustment to reflect actual costs. Such an adjustment usually may be made by use of the ratio of actual to standard costs during the period under review.

If actual costs are greater than standard costs, separate treatment may be indicated with respect to price variances and usage variances. It may be desirable to restore price variances to the valuation of inventory. On the other hand, adverse usage variances may be deemed to be the result of inefficiencies, and consequently their absorption in the current period would be justified.

Along this same line, if price variances are recognized in the accounts at the time the purchased material is received into stock, consideration should be given to whether or not adjustment of inventories to a cost basis by the ratio method is sufficiently accurate. While work-in-process inventories and finished-goods inventories may be considered to represent a fair cross section of the company's products, and consequently adjustments of standard costs by the ratio method may be equitable, the same reasoning may not apply to raw-material inventories. At the balance-sheet date the raw-material inventories may be heavily weighted with the materials which give rise to the variations or, on the other hand, may be practically devoid of those materials. It may be necessary to reprice raw-material inventories on a lower-of-cost-or-market basis or at least to reprice a substantial portion of the items to arrive at the appropriate adjustment.

Related to the foregoing questions, but perhaps even more closely concerned with current internal reports of the results of operation, are the problems involved in setting price standards for commodities subject to frequent fluctuations in market prices. There are many difficulties involved in establishing procedures which, on the one hand, provide equitable bases for managerial control and comparisons with actual performance and on the other hand reflect fair inventory valuations, at the same time avoiding the necessity of too frequent changes in standards with accompanying changes in detail inventory records. Perhaps a solution which should receive more general recognition is the use of a constant or basic standard within rather wide limits of actual market conditions, coupled with the use of cost-index ratios for the proper interpretation of balance-sheet positions and results of operations.

Labor Variances

Experience indicates that labor standards are generally adverse, that is, actual labor costs exceed standards. This condition is quite natural as the labor standard is usually an expression of desired performance, thus providing a basis of comparison with actual results and a measure of labor efficiency. There are instances, however, where substantial cost reductions have been effected even in the face of increasing wage rates. Where the standards themselves have not been changed, it then becomes necessary to adjust the labor component of inventory to reflect the lower actual cost.

As I first mentioned, however, the more common condition is where actual labor costs exceed standards. In some instances, labor standards are changed to give effect to increased wage rates but are not revised sufficiently rapidly to keep up with changing conditions. Before deciding on the proper treatment of variances in the accounts it is desirable to make an analysis of the reasons for the labor variances. Those which arise from a production performance at a lower level than that which is considered practically attainable should probably be written off against the current period. On the other hand, variances which are due to wage rates in excess of those in effect when the standards were established are a proper addition to the inventory price base.

A peculiar problem arises in connection with the treatment of overtime bonus and night-shift bonus in those cases where an entire plant is working on a lengthened schedule of working hours and on several shifts. I shall refer to that later, however, in discussing some of the problems resulting from present-day conditions.

Overhead Variances

The principal problem in connection with a reflection of overhead costs in financial statements of course deals with the treatment of over- and underabsorbed overhead. As you all know, a balance of overabsorbed overhead at the balance-sheet date indicates, normally, that production costs for the year have been overstated and it is then necessary, in preparing financial statements, to determine what portion of this overstatement is applicable to the cost of goods produced and sold during the year and the portion applicable to goods in the year-end inventories. As a general rule, the task of making this apportionment can be simplified by ignoring minor items of inventory and limiting the items to be considered to those comprising the largest proportion of the inventories in point of value. Then a comparison of quantities produced and sold during the year with quantities in inventory will usually provide a substantially accurate percentage for apportionment. In many cases, however, it will be found preferable to use a shorter period, probably toward the end of a year, in order to be able to base the percentage on production periods in which the kinds of goods produced are comparable to the classification of products in inventory.

Underabsorbed overhead, on the other hand, involves us in the possibility of understated inventory values which might unjustly penalize operations for the current year. This condition must be carefully examined to determine whether the underabsorbed overhead resulted from an understatement of production costs through the application of an overhead rate which is incorrect because of current conditions, or from some other cause such as lack of volume sufficient to utilize normal plant capacity. In the latter instance (where normal capacity has not been utilized), a charge to income for the entire amount underabsorbed would be indicated.

The treatment of over- and underabsorbed overhead in interim statements has presented many problems. If the operations are seasonal and experience indicates that operations for the remainder of the year will absorb the over- or underabsorbed charges, they may properly be treated as deferred items in the financial statements. However, treatment equivalent to that for the year end should be employed where no such explanation is possible.

I shall not attempt here to define normal capacity or normal overhead rates. However, I do want to mention that in spite of all that has been written and said on this subject, many so-called normal or standard overhead rates in use today have little relation to the operating facts of the particular business. For example, in an inventory heavily weighted with work-in-process and finished product, in which overhead is a substantial portion of production costs, the changes which may be made in indicated financial results by variations in the application of overhead are frequently substantial. The safeguards, at least with respect to the income account, which ordinarily resulted from the use of consistent rates from year to year, are threatened by the effect of the tremendous expansion in operating capacities which is now taking place.

This brings us to the discussion of some of the standard cost problems which are brought about by present-day operating conditions.

With the necessity for expanding manufacturing facilities, many manufacturers have acquired additional equipment. In some cases this equipment is more modern and consequently superior to equipment previously in use. In other cases, the manufacturer has had to content himself with equipment less adaptable to the purpose and less efficient than his normal equipment. In still other cases, the manufacturer has found it necessary to furnish material to smaller coöperating companies who perform the required operations on a cost-plus basis. In all of these cases the resultant labor costs will probably be at variance with the previously established standards. In fact, the operations themselves are frequently not the same ones as those upon which the standards were set. Several operations may be combined into one operation on improved equipment or the reverse may occur, and what was previously one operation, now is two or more. Revisions of standards, even if practicable in view of the pressure of work and the shortage of qualified personnel may not be the solution, for the reason that today there may not be one accepted standard method but all of the various methods of performing the work may be going on simultaneously. It seems to me that management, in using comparisons of actuals with standards as a tool of managerial control, must recognize that present-day conditions have created many new problems.

Also, problems are presented as a result of the use of substitute materials in place of those with respect to which there is a shortage due to their strategic value. Not only do we have the problem of changing material costs but we are faced with changed quantities and changes in the character of labor operations performed thereon.

Previously I touched briefly on the effect of overtime on standard cost procedures. Under normal conditions overtime, whether treated as direct labor or overhead, is eventually reflected as a variation from standard and is thus disposed of. Today, however, many companies are working five or six ten-hour days with two shifts. The application of time and a half for overtime work in excess of 40 hours a week (plus usually a 10 per cent bonus for the night shift), in effect results in an increase in hourly wage rates of approximately 15 per cent. A good case can be made for treating such bonus payments as increases in wage rates with related increase in the inventory price base.

Companies whose products have a commercial, as well as a military application, and which manufacture essentially for stock, recognize that within a year, or at most two, their entire finished-product inventory may well contain a labor component which is some 15 per cent above the basic rate, and *that* basic wage rate may soon be higher. Managements realize that at the termination of the emergency at least the overtime increment in the inventory value may have to be written off almost immediately. Consequently, some far-sighted managements are charging all overtime bonus and night-shift bonus direct to cost of sales in the months in which they are incurred. Of course, in those instances where the supplier is working on a cost-plus contract he should arrange as an intermediate step to charge the appropriate amounts of overtime bonus and night-shift bonus to the specific contracts affected. In that case the charge to cost of sales is merely deferred until the contract itself is closed out.

Subcontracting of complete parts or assemblies. as distinguished from subcontracting labor only, presents another set of problems. In the case of certain parts, a portion of requirements may be manufactured in the company's plant and a portion purchased from subcontractors. The price paid subcontractors is probably not only different from the company's manufacturing standard cost but it is introduced into the inventory as purchased material compared to the company's product which contains the elements of material, labor, and overhead.

Brief reference has previously been made to the effect of plant expansion on normal overhead rates. Let us first consider the case of the manufacturer whose experience under pre-emergency conditions was one of chronic underabsorption of overhead. Today the overhead is overabsorbed as a result of increased volume of production, coupled possibly with increased plant facilities. In this case there does not appear to be an immediate problem. We simply apportion the overabsorption between inventories and cost of sales. However, it may not be too early even now to give some thought to methods of determining normal capacity and normal overhead rates at the expiration of the emergency. In many cases it is doubtful, in view of changed facilities and other conditions, whether simple reversion to the old rates will be satisfactory. In other cases the old rates never were correct. Their principal virtue was consistency from year to year. A similar problem occurs in the case of the manufacturer who before the emergency experienced overabsorption of overhead, but at the present time has even a greater overabsorption than before.

Let us next consider the case of the manufacturer who even before the present extensive manufacturing program experienced overabsorption of overhead, but today, in spite of greatly increased operations, is found with underabsorbed overhead. This situation is not uncommon and is caused by unusually large expenses prior to commencement of full production. Examples of such expenses are training of personnel, acquisition of new tools, rearrangement of machinery, etc. In these circumstances it becomes necessary to consider the advisability of deferring such extraordinary expenses to the production period which will incur benefits therefrom. A similar situation exists in those cases where normal experience has been one of underabsorption of overhead and where in spite of increased production there continues a condition of underabsorption due to extraordinary expenses resulting from increased facilities.

Standard Cost Problems Arising as the Result of Requirements in Accounting for Defense Contracts

Government contracts in which cost is a factor in computing the amount due the supplier do not recognize standard costs as authentic statements of the cost of performing a contract. However, the use of standard cost is permitted as an intermediate step in the manufacturer's internal accounting for the purpose of arriving at actual costs. I am going to take the liberty of quoting one sentence from T.D. 5000, which is the controlling document in many government contracts for purposes of cost determination,

"In cases where it has been the custom in the past to use so-called 'normal' rates of overhead expense or administrative expenses, or 'standard' or 'normal' prices of material or labor charges, no objection will be made to the use temporarily during the period of performing the contract or subcontract, if the method of accounting employed is such as clearly to reflect, in the final determination upon the books of account, actual profit derived from the performance of the contract or subcontract and if necessary adjusting entries are entered upon the books and they explain in full detail the revisions necessary to accord with the facts."

This procedure will be recognized as paralleling conventional basic standard cost procedures in which the basic standards are used as a yardstick for comparison with actual costs but do not appear in the accounts in the final determination of the results of operations. In some cases where standard costs supposedly have been adjusted to actual by the use of cost ratios, Army and Navy auditors have rejected overall ratios of actual to standard and have insisted on breakdowns of variances by producing departments to the extent necessary to make a fair and reasonable determination of true costs.

In plants working exclusively on cost-plus-a-fixed-fee contracts there is frequently no occasion for the use of standard costs. However, in the case of one company which has come to my attention, one of its plants is operating on cost-plus-a-fixed-fee contracts and another plant on fixed-price contracts. The accounts are based on standard cost procedures. In order not to disturb its normal accounting methods and at the same time keep the records on the cost-plus-a-fixed-fee contracts on an actual basis, thus avoiding the necessity of adjustments from standard to actual, this company keeps accounts on both bases at the cost-plus-a-fixed-fee plant. One set of accounts is at standard costs and one at actual costs, the latter having a set of contra accounts to eliminate from the records the actual costs, which are used solely for purposes of obtaining government reimbursement.

This same company has occasion to make interplant shipments and on the cost-plus-a-fixed-fee contract the government is recognizing standard costs of the interplant items as a basis for reimbursing the contractor subject to quarterly adjustment of such costs to actual, based on the experience of the plant which made the shipment.

An interesting experience may be related in connection with Vinson act contracts, some of which are still open. The company in question assumed that it was merely acting as a material supplier shipping its products from stock and was surprised to learn that it was subject to the Vinson act and would be expected to file reports thereunder. The company maintained no product or contract costs whatever and was faced with the alternative of reconstructing such costs several years after the fact or paying tax on its overall percentage of profits, which latter alternative was undesirable.

Standard costs were prepared on the basis of current material, labor, and overhead costs for all products and in detail by material classes and labor operations. (There had been no material change in products or methods of manufacture in the intervening years.) Production in the prior years was priced at the standard costs prepared in this manner. The standard costs were then adjusted retroactively to the actual experience of the Vinson act taxable years. This procedure was accepted by the Treasury Department for the purpose of computing taxes due under the Vinson act. The procedure, of course, is merely an adaptation of the conventional method of adjusting standard costs to actual, but the application thereof to the computation of actual costs in a period prior to the establishment of the standards is unusual.

The foregoing exposition of experiences and problems with standard costs under present conditions may cause one to pause before embarking on a standard cost system where reasonably satisfactory cost methods are in existence. However, in closing, I think I ought to emphasize that, difficult as some of the problems have been, they have not been insolvable, and there is no necessity for abandoning standard cost systems which are in successful operation.

Accounting Treatment of Unusual and Extraordinary Costs

BY LOGAN MONROE, OHIO
Member, National Association of Cost Accountants

IN TIMES of accelerated production, unusual and extraordinary costs paradoxically become both usual and ordinary. We are now in such times.

Although nearly all abnormal items of cost now being experienced by manufacturers are the result either directly or indirectly of the defense program, this paper will not deal to any great extent with the specific problems arising from them under defense contracts, as this subject is well covered by other papers. It will deal, however, more generally with the problems encountered by the manufacturer devoting part or all of his facilities to the production of his regular products and for his usual markets.

There exists very little written opinion on the proper accounting treatment of unusual and extraordinary costs. Upon reflection, this lack of opinion is neither unusual nor extraordinary. Before a physician can intelligently prescribe the treatment for the patient, he must first diagnose or define the ailment; and so it is with the accountant. He must know what he is to treat before he can properly apply the treatment.

When one considers that even today we do not have a completely satisfactory definition of normal cost, it is not surprising that comparatively little authority exists in regard to the definition and treatment of abnormal cost. The original and detailed subject of this paper did, however, assume that overtime premiums, training costs, excess spoilage, and substitute materials are unusual and extraordinary. On the same rather broad assumption, we may consider other abnormal costs to include excessive set-up, unusual production bonus payments, initial vacation pay to hourly workers, retroactive wage increases, excess material transportation costs, increased costs due to subcontracting, second and third shift premiums, and many others.

But we cannot say positively that these costs are always unusual and abnormal. On the contrary, the first problem presented to the accountant is to decide by careful scrutiny and analysis whether the conditions causing them justify the definition of unusual and abnormal.

In some plants, overtime during an extended depression might be quite unusual, but in normal times may be considered an expected and usual thing. Or, it might seldom be incurred in producing one product of a company, but due to demands of customers or the nature of some other product of the same company, overtime on that latter product may be expected and normal even in times of relatively low business activity.

Similarly, a large amount of spoilage might be experienced in an industry or on some product and be considered part of the usual or normal cost, while an equal amount of spoilage in producing the same product in a different factory or by a different process may well be considered extremely unusual.

Training costs to provide for the normal turnover and replacement of employees is not unusual, but when conditions suddenly require three-shift operations in a plant normally working only one shift, the resulting training costs would certainly be somewhat extraordinary.

Each of the other abnormal items

mentioned above could be analyzed in a similar manner and each would present its own peculiar aspect of the same basic question, Is it truly unusual and extraordinary?

After solving the first problem and once determining that the item is unusual and extraordinary, the second problem presents itself, that is, how properly to reflect this cost in the accounting records. Apparently the accounting profession has adopted no very definite rule in respect of unusual and extraordinary costs. The last time this problem was of any magnitude for industry was during the last World War, and industrial or cost accounting at that time was somewhat elementary. During the twenties, extraordinary *profits* were the rule rather than extraordinary *costs*, but in the last decade, industry has experienced a succession of causes tending to produce extraordinary costs — first, the unionization of industry, then social legislation, to be followed more recently by the tremendous impact of the defense program; so that today all industries, large or small, are faced with items of cost which are not only unusual but at times bewildering.

In August of this year a research study was published by the National Association of Cost Accountants which reflected the practice of approximately 300 representative companies in regard to excess or abnormal costs. While this study did not profess to recommend any specific treatment, it did reflect the practice of a sufficiently large number of companies to indicate that there is still today a surprising lack of uniformity in the treatment of such items. This study showed that there are three general practices, but with numerous modifications and qualifications.

These three general methods are:

1. Inclusion of the excess amount in the cost of the job or product which apparently caused it.
2. Inclusion of the excess amount in overhead, thus spreading it over all production of the period.
3. Segregation of the excess amount into appropriate variance accounts and included in cost of sales, profit and loss, or administrative expense of the period.

While every abnormal item of cost presents its own peculiar problem, all of them have the common characteristic of being unusual and a discussion or analysis of any one of them will apply to some extent to all of them.

Because overtime premiums today are probably more frequently encountered than any of these other unusual costs, it may be well to study the varying results obtained in the treatment of this abnormal item if treated in accordance with each of the three general practices mentioned above.

Let us consider the first case—*when abnormal overtime premiums are included in the cost of the job or product which apparently caused them.* This practice is not encountered where standard costs are used, as standard or normal labor naturally will not include an abnormal item. It is true that some standard costs will include a normal amount for overtime premiums, but as a normal cost they are outside the scope of this discussion.

As might be expected, the inclusion of these premiums in the direct cost of the product is encountered where so-called actual costs are recorded. Under an actual cost system the question of abnormality is less pronounced than with standard costs. The actual cost advocate goes on the theory that cost is cost regardless of the resultant variation between jobs and periods, and if overtime premiums are paid while the job is being processed, that job will ordinarily bear the additional cost. But will this theory stand up under analysis?

While it may sometimes happen that a specific job which must be rushed is directly responsible for the overtime hours, this is not the primary cause of overtime now. Only in the case of large construction projects or large units of product, such as a ship or a building, can the individual job or process be considered responsible for the overtime.

Today, in the majority of cases, overtime is necessary not because of any one job, but because the total work required on all jobs exceeds the capacity of the facilities available with the labor force working only the forty hours allowed by law before overtime applies. Under these conditions, the particular job worked on during the overtime hours is not responsible for the overtime premium. As a matter of fact, the reverse is usually true. The rush jobs are started first and the others, placed further along the schedule, are processed on overtime because the rush jobs have already consumed the normal day or week.

It might be well to note in this connection the problem created where production involves both government and commercial work. If overtime premiums are charged as direct costs to the jobs worked on, management must accept the responsibility of deciding what jobs shall be processed during overtime hours. This, in addition to being an almost impossible task, would probably conflict with the opinion of the government.

The research study of the National Association of Cost Accountants, previously mentioned, referred to the *Goodyear—Sears, Roebuck* case where the government was sustained in its viewpoint that savings in manufacturing costs arising from a large order using previously unutilized capacity, was not a saving to be applied to the new order only but should be spread over all production. Conversely, the government would probably support the contention that when total production is so great as to make overtime necessary, the additional cost due to overtime premiums should be apportioned to all production and not applied solely to the jobs which happen to be worked on during overtime hours.

In addition to distorting the true cost, another result of charging overtime premiums to direct labor is that such a procedure temporarily capitalizes such costs in inventory valuations. And, if actual overhead is used instead of normal (and some companies still do this), the distortion is heightened when this actual overhead is prorated on the basis of direct labor.

There is a serious question as to the propriety of carrying such costs forward in inventory values. Unusual and extraordinary costs cannot be considered elements which properly contribute to sound inventory values. When volume and prices turn down, as they inevitably will, it will be too late to recover these costs. Inflated inventory values now mean high profits and high taxes, which will be offset by inventory write-downs with the next downward swing of the business cycle. In recent years much consideration has been given to the last-in, first-out, and related methods of inventory valuation, with a view to eliminating or reducing the inventory write-downs which come with a period of falling prices and reduced activity. Inflated inventory values on work in process and finished goods, as a result of capitalizing excess costs of peak production, may in many cases create as large inventory write-downs as will raw-material price changes. Let us hope that incorrect accounting procedure with respect to unusual and extraordinary costs created by the defense program will not be a contributing cause of a repetition of the shocks experienced by industry following the first World War in 1920 and 1921, which were created substantially by inventory write-downs and adjustments.

We will now consider the second general treatment accorded this unusual item of cost—that is, *when abnormal overtime premiums are included in overhead, thus spreading them over all produc-*

tion of the period. Under an actual cost system using actual overhead, these premiums would be spread over all the work processed during the period and be temporarily capitalized in inventories until the product is sold.

While the distortion of costs on the individual job is less under this method than when these premiums are charged to direct labor, it would appear that this plan would still produce, in total, the same effect on inventories—except that the inflation would be spread over all the product rather than over a particular article or class of product.

When this procedure is followed under an actual cost system, but using *normal* overhead, or under a standard cost system, this excess cost becomes underabsorbed burden and is usually charged directly to profit and loss, and inventory valuations are not affected. If, however, burden variance is prorated between cost of goods sold and inventories, a portion of the excess cost will naturally be included in the value of inventories.

Now let us look at the third method of reflecting this extraordinary cost in our accounting records—that is, *when abnormal overtime premiums are segregated into appropriate variance accounts, and included in cost of sales, profit and loss, or administrative expense of the period.* This method would appear to have advantages over the two already discussed. This is the method by which the excess cost is charged to a variance account and written off currently, either to cost of goods sold, profit and loss, or even to administrative expense. By this method, the objection to capitalization in inventories is eliminated. In addition, an analysis as detailed as desired is possible, and if as a result of this analysis some of this excess can be legitimately charged to specific jobs through cost of sales, the facilities are available.

That portion remaining which cannot be directly allocated to any particular job or product may then well be considered a direct variance chargeable to profit and loss for the period.

To charge such items to administrative expense may upon first consideration appear somewhat unorthodox, but in the particular case of overtime premiums there might be some justification for this. Such costs are usually the result of lack of facilities or an unbalanced condition. When we pay interest for lack of capital, it is considered an administrative expense, and it might well be argued that excess costs due to lack of equipment could be classified in the same manner. At any rate, this method does retain the advantage of liquidating the cost in the period in which it occurred.

While the preceding examples have been confined to the consideration of only one kind of unusual cost, a similar analysis of the others will disclose that the same general conclusions and principles will govern.

It is possible that *excess spoilage* might often be included more logically in the cost of a particular job than would overtime premiums, but if this excess spoilage were caused by a large addition of untrained workers, it could hardly be said that any particular job was the cause of it. Similarly abnormal *training costs* of these same workers should not penalize the individual jobs which by chance were being processed at this time. On the other hand, if it were necessary to train this group of new employees because of the addition of an entirely new line of product requiring qualifications not possessed by old employees, such training costs would be legitimate additional costs to this new product but included in cost of sales by means of variance accounts.

Payments made for *retroactive wage increases* should certainly not increase the cost or inventory valuation of products manufactured at a later date. So could all of these various unusual and extraordinary costs be considered and the same conclusion be drawn. The very fact that we have decided they are unusual and extraordinary should indicate that they are no part of our regular or normal cost.

The question then will be asked: If these items are not to be considered as applicable to the cost of any product produced in this period, then how are they ever to be recovered through selling price? This brings us to the question as to just why are costs accumulated, which is in itself a question large enough for considerable discussion.

Costs serve many purposes; inventory valuation, cost control, and pricing are three of the more important uses. Each of these is in itself a large subject but it would seem that the use of standard costs, with these unusual and extraordinary items charged to sufficiently detailed variance accounts, comes closest to fulfilling the requirements of these three most important uses of costs.

Inventories are not inflated but kept at a normal or near constant valuation. Variances, when sufficiently analyzed, give the best possible managerial control through the principle of exception, and the study of the standard costs together with all variances should produce a much better source of intelligent pricing than would widely varying costs containing abnormal items arbitrarily prorated or mistakenly charged.

Furthermore, the speaker is not of that school which believes selling prices are established solely from costs. On the contrary, it is his belief that more often cost is governed by the selling price. As a factual example: Some years ago a large manufacturer of automobiles came to the conclusion that quantity production of cars could be achieved only by establishing a selling price within the reach of the average working man. With this thought in mind he told a committee of his engineering, manufacturing, and cost executives to estimate the minimum manufacturing cost for his car on a hitherto unheard of production basis. After several weeks the committee announced to him this minimum estimated cost figure. He immediately wired his dealers throughout the country that effective the following day the selling price of his car would be substantially *less* than the estimated minimum manufacturing cost which his committee had given him. At the end of the year he had broken all production and sales records and had produced the car at a cost which allowed him a comfortable margin of profit. Be that as it may, if actual costs are desired for the purpose of establishing selling prices, it is quite simple to convert standard costs to more accurate actual costs if variances are correctly analyzed and recorded in sufficient detail. At the same time, the several objections to usual actual costs are eliminated.

These excess and abnormal costs have another insidious and dangerous characteristic. They first appear when production is all important. High costs are expected, and although analysis might indicate that these are of startling proportion, they do not arouse undue concern. The demands of production predominate, and unfortunately these extraordinary costs usually tend to increase in more or less gradual steps so that soon they are apt to be considered as part of normal cost. Unfortunately, they rarely recede of their own account. There is a constant tendency for them to remain high or go even higher, and when the time comes that these extra costs cannot be afforded, it is usually too late to reduce them in any but a destructive manner.

Familiarity breeds contempt. Unusual and extraordinary costs will always be with us to some extent, and each different one will continue to present its particular problems. But if we will continue to recognize the fundamental fact that they really are unusual and extraordinary and we reflect this basic fact in their accounting treatment, the problems they present can be reduced to a comparatively pleasant minimum.

Accounting Treatment of the Cost of Defense Facilities

BY R. W. PEDEN, MICHIGAN
Member, National Association of Cost Accountants

I CONSIDER it a rather singular privilege to be assigned to speak to your convention because for many years I have sat on the opposite side of the table to some of your capable members, seeking counsel on problems similar to those I have been requested to discuss today.

I can truthfully testify that this counsel has been not only sound but at times brilliant and creative. The amazing development of Detroit industry has not been caused entirely by inventive genius in the mechanical realm nor by mass production techniques such as the development of the assembly line. It has been stimulated financially and economically by the most capable accounting, tax, and management service on the part of Michigan firms of certified public accountants. I can bear personal testimony to the fact that there are in this state today flourishing and successful corporations which owe not only their continued existence but also their present success to the high type of accounting service rendered by Michigan accountants during times of crisis.

I shall attempt to discuss four principal topics as follows:

1. The amortization deduction as it applies to defense facilities.
2. The present-day treatment of depreciation, particularly accelerated depreciation resulting from defense production.
3. Cost problems arising from multiple shifts or continuous operations.
4. The pricing situation which will result from the resumption of normal peace-time production.

I. THE AMORTIZATION DEDUCTION

Any attempt to explain the federal statutes and regulations pertaining to this subject would be incomplete without some brief comment on the experience of the Nation upon the termination of World War No. 1. Because the regulations of the revenue act of 1918 laid down only vague and general standards for the determination of post-war amortization allowances, the settlement of the majority of contracts with the government was attended by gross overpayments, charges of political corruption, and litigation in the courts for many years. The Couzens Committee which was appointed by Congress to investigate the subject reported to the 69th Congress that amortization allowances had been granted in 3334 cases in amounts aggregating $596,934,812.26. After reviewing all cases involving more than $500,000, the same committee concluded that improper allowances had been made to the extent of $210,665,360.40. Some of these cases were transferred to the war-contract audit section of the Department of Justice for final adjudication, and so involved were the legal proceedings that it was as late as the year 1940 before the final case was settled by the courts.

It was not strange, therefore, that when the present emergency developed and the President appealed for the support of the business interests of the country the appeal was received with a certain degree of apathy. It would be unjust to describe the situation as a "strike of capital," but it was only natural that businessmen, who remembered the litigation following World War No. 1 should want definite assurances from the government for the protection of their investments. The result was the revised income-tax law of 1940, whereby corporations subject to government approval may deduct in their tax returns the entire cost of defense facilities within a period of sixty months or five years.

In formulating this statute the government has made a distinction between amortization for tax purposes and amortization as it might affect pricing. The theory has been that if a sufficient saving in taxes were offered the taxpayer through the amortization feature it would not be necessary for the government to pay for the cost of defense facilities again through inflationary prices which included depreciation.

To understand the rôle of amortization in accounting for defense facilities, however, it should be explained that there have been evolved three major types of financing defense projects:

Plan number one provides for the investment of private capital *without* reimbursement.

Plan number two provides for the investment of private capital *with* subsequent reimbursement under an emergency-plant-facility contract.

Plan number three provides for financing directly by the government through the War Department, the Navy Department, or the Reconstruction Finance Corporation.

Obviously, there can be no amortization problem in connection with plan number three; amortization is applicable only in those cases involving financing by private capital. Contrary to original expectations the most popular type of financing seems to be the last. One explanation is that under the R.F.C. it is necessary to charge only 40 per cent of the contract amounts against available appropriations, whereas under the emergency-plant-facility contract it is required that such amounts be charged immediately. Another explanation is that the taxpayer is reimbursed every month for all approved vouchers.

Amortization has been held to cover such assets as land, buildings, machinery or equipment, the construction or installation of which was completed after June 10, 1940. It has also been interpreted by eminent authorities to cover a patent or even a working model of a project. It may be taken only by corporations because only corporations are subject to the excess-profits tax. The base date of June 10, 1940, was a compromise because it was obviously necessary to establish a definite time prior to which any investment in facilities should not be construed as having been undertaken for defense purposes. The deduction for amortization is allowable only if the corporation elects to take it rather than to take ordinary depreciation, and it may begin with the month following the date of the acquisition or with the taxable year immediately following. In either case, however, the taxpayer must state which period has been selected. It is also allowed for both income and excess-profits-tax purposes. The amortization period terminates on the date when the President proclaims the emergency period has ended, or on a date specified by a certificate issued by the Secretary of War or the Secretary of the Navy.

The statute is designed to encourage the investment of private capital and yet to protect the government by vesting the title in the government at the end of the period, if advisable. The contractor is not permitted to include any charge in the price of his product for amortization in excess of normal depreciation. It is the intent of the government that any taxpayer receiving the amortization privilege shall not include any amortization in the price of his product. The assumption is that the savings in taxes alone may prove to be sufficient.

A clearer conception of the legal aspects of the relationship is to be found in the explanation of the three types of certificates required in connection with emergency-plant-facility contracts. The first is called the certificate of necessity.

If a taxpayer is to be fully protected with respect to the amortization feature, he must have one of these certificates for each separate major facility. In addition, he must have either one or the other of two additional certificates; namely, the certificate of government protection and the certificate of nonreimbursement. The former is intended to protect the United States with reference to the future use and disposition of the facility even after the expiration of the present emergency period. The latter, or the certificate of nonreimbursement, relates to the government's price policy. The Defense Commission denies these certificates in emergency-plant-facility cases unless the price of the supplies excludes all charges for depreciation.

The following products have been specifically held to come under the purview of necessity certificates:

Chemicals
Petroleum
Coal and gas products
Ammunition shells and bombs
Guns
Aircraft
Aircraft engines, parts and accessories
Vessels
Motorized vehicles
Nonferrous metals, including aluminum, magnesium, tin, tungsten, and zinc
Electric and other machinery
Textile mill products
Rubberized fabrics
Optical and medical instruments

Under the provisions of the contract the contractor is required to insure the facility, maintain it, and hold it free and clear of liens and other legal encumbrances.

Through T.D. 5016, the Treasury Department has ruled that the amounts received by a taxpayer in connection with its agreement to supply articles for national defense, though they are specified to be reimbursements for all or part of the cost of an emergency facility, must not be treated as capital receipts but are to be taken into the accounts as income. In other words, by reporting the receipts as income and by spreading the total deduction over a sixty-month period the taxpayer is able to "wash" the transaction and effect a substantial saving in taxation.

Another important feature of the law is that defining the "adjusted basis." If, for example, a corporation has expended $1,000,000 on a facility and if $300,000 of this was expended prior to June 10, 1940, $700,000 is the "unadjusted basis" or the amount subject to amortization. This phase of the subject has been most ably delineated by John D. Filson in the February, 1941, issue of *The Journal of Accountancy*. The adjusted basis at the end of each month is the original unadjusted basis, less allowed depreciation, less amortization taken, and less special deductions such as fire losses.

The amount of the amortization to be taken each month is held to be an amount equal to the adjusted basis of the facility at the end of the month (without reduction for amortization for such month) divided by the number of months (including the month for which the deduction is computed) remaining in the amortization period.

As the amortization feature is inextricably a part of the standard emergency-plant-facility contract I believe the following summary of the salient features of this contract as listed by Donald Russell in the *Lybrand, Ross Brothers & Montgomery Journal* for May, 1941, is not only accurate but all inclusive in its description:

1. The contractor retains the title to the facility during the emergency.
2. The contractor agrees that the price of the product will eliminate all charges for amortization and depreciation.
3. The contractor agrees to report monthly and at the end of the emergency period.

4. The cost of construction is not to include any profit, but may include amounts for services.
5. The total cost is to be repaid in sixty monthly installments.
6. The contract may be terminated by the government at any time and, under special conditions, it may be terminated by the contractor. If this happens the balance not paid is to be paid by the government.
7. If the contractor desires to retain the facility he has two options.
   (a) An option to pay the government the *original cost* less depreciation and to secure a release.
   (b) An option to negotiate for a *fair value* and to secure a release.
8. The government keeps the title, or the contractor may lease it.

The status of subcontractors is naturally a vital point. The rule seems to be that the subcontractor is entitled to the amortization deduction upon the basis of the necessity certificate allowance. In other words, the subcontractor may avail himself of the protection of the law, but he must prove to the government his rôle as a subcontractor.

Of particular interest to the accounting profession and corporation controllers is the necessity of keeping detailed and adequate records of all of these transactions. The following records seem to be of vital importance to the taxpayer:

1. A description of the facility.
2. The day on which the contract was begun.
3. The date of completion.
4. The date of the certificate of necessity.
5. The date amortization was begun.
6. The date amortization was discontinued.
7. The nonadjusted basis of the facility.
8. The adjustments to such basis.
9. The amount of the monthly amortization.
10. Supplementary information regarding the facility.

To summarize, the primary benefit and value of the amortization deduction to the contractor is the substantial saving possible because of the avoidance of the excess-profits tax. Since the reimbursement payments are construed to be income and since the contractor is permitted to deduct his entire cost over a period of five years, or during the period of the emergency, whichever is shorter, it is obvious that he can enjoy an advantage from the emergency program which is not permitted to him for his normal peace-time production. Furthermore, if the federal tax rate should decline rather than increase after the period of the emergency, the taxpayer will have gained substantially by the protection of the amortization privilege during the crisis.

II. The Present Day Treatment of Depreciation, Particularly Accelerated Depreciation

One of the immediate effects of the emergency upon accounting theories and practices is an increased emphasis upon depreciation in all of its aspects. The inadequacy of the present methods of handling this subject was forcefully illustrated by Professor Herbert Taggart in a recent issue of the *Accountants Digest.* Professor Taggart emphasized the fact that current practice is to interpret depreciation as a complex of a number of factors such as the following:

1. Ordinary "wear and tear" in use.
2. Unusual damage or deterioration.
3. Exhaustion.
4. Limited possibility of use.
5. Inadequacy.
6. Obsolescence.
7. Cessation of demand of product.

Without question most of the reserves which are regularly accumulated by the average corporation controller make no distinction between depreciation and obsolescence. In fact, the rates in general use are assumed to cover the total deterioration in financial value.

The present status of the accounting treatment of this subject can be illustrated by developments in other professions and in other branches of knowledge. There was a time, not many generations ago, when most of our modern natural sciences such as biology, psychology, mineralogy, geology, chemistry, and physics, were crudely grouped in university curricula under the broad caption of "natural philosophy." As speculation yielded to research and as scientific facts supplanted scholastic opinions and dogma, "natural philosophy" disintegrated and the specific sciences were born. The first to appear was physics. Later came biology and chemistry. The latest loss to "natural philosophy" is psychology. Is it not logical to believe that this elusive subject of depreciation is as susceptible to scientific classification and study today as "natural philosophy" was a century ago?

Not only is the emergency period challenging the all-inclusive aspect of depreciation; it is also challenging the current practice of considering it primarily and exclusively as a function of time. With thousands of factories now operating with multiple shifts the question of relationship between production on the one hand and physical deterioration on the other is assuming more importance. The government has already established certain precedents on this subject. In section 19.23(1)5, of Regulations 103, the Treasury Department said, "The capital sum to be recovered should be charged off over the useful life of the property either in equal annual installments or in accordance with any other required trade practice, such as an apportionment of the capital sum over units of production." Furthermore, in T.D. 4906 which applied expressly to Vinson act contracts, now temporarily suspended, the Department stated: "In making allowances for depreciation, consideration should be given to the length and number of shifts." Moreover, the yearbook of the National Association of Cost Accountants for 1941 contains further confirmation of this view. In the panel discussions of this subject in New York, members acknowledged the rulings of the Treasury Department to the effect that extra depreciation was allowed in specific cases where conditions were held to justify it.

Here again Michigan may show the way out. We have in this state two flourishing industries in both of which depreciation is considered as a function of use rather than time. The first is one of our large and successful public utilities, the eminent president of which has always insisted that the depreciation for his equipment is proportional to service rendered rather than to a mere lapse of time. The other business, the motor-transport industry, is one by the very nature of which, depreciation depends upon miles traveled rather than the lapse of time. These examples are offered to emphasize the need for further scientific analysis of the subject of depreciation by the accounting profession.

III. Special Cost Problems Arising from Multiple Shifts or Continuous Operations

In our analysis of the effects of multiple shifts or continuous operations upon costs we are aided by the normal peace-time experience of certain basic industrial processes such as the working of blast furnaces, soaking pits, and open hearth furnaces in the steel industry, and extruders, piercers, and hot rolling equipment in the brass industry. In such industries it has been standard practice to operate the equipment continuously. This is desirable because of two essential facts:

1. The high cost of starting.
2. The high initial cost of the equipment, making full utilization important.

In the particular corporation where I am now employed the base tube-forming units have always been operated twenty-four hours a day, and the normal burden rates have been calculated on this basis, with due allowance, of course, for maintenance, shut downs, etc. The normal basis of operations for the remainder of the plant is one shift.

Because of the present high level of business volume in recent months, however, it has been necessary to operate these units twenty-four hours a day for seven days in a week, instead of twenty-four hours a day for five days a week. In addition it has been necessary to operate the finishing departments for two and even three shifts a day. Because we have "day work" throughout the plant and a contract with a union, certain employees have been receiving the following premiums:

1. A premium of five cents an hour for second and third shift work.
2. Time and one-half for Saturday work.
3. Double time for Sunday work.
4. A premium of 10 per cent of the regular hourly rates for producing 10 per cent in excess of the regular standards.

In our accounting we have attempted to differentiate between those premiums which are the result of the exigencies of the times and those which are more regular. Accordingly, we have charged the night shift premiums and the 10 per cent production bonus to the regular direct labor costs of the operations and the overtime premiums to a special burden account.

A questionnaire recently conducted by the research department of the N.A.C.A. on this subject may be of general interest to all accountants. It reveals that corporation practice has varied with respect to these subjects. To what extent the burden rate structure of a corporation should be revised to reflect present conditions is one which is naturally dependent on the nature of a corporation's business. We have the same problem confronting us with respect to the excess direct-labor costs resulting from labor's present inefficiency. It is my own conviction that if a time study standard indicates 1,000 units an hour is attainable by a normal operator working under normal conditions, then 1,000 pieces an hour should remain the standard and should be used for labor control, cost accounting, and estimating. If, however, it is apparent to the management that the slow down is permanent rather than temporary, some loading factor should be used although I prefer to have it added as a separate and distinct item. We have in Detroit large and successful corporations where standards have never been changed for control, cost, or estimating purposes during all of the difficulties of the last few years. These corporations believe it is not sound to pass on to their customers in the form of higher prices all such excess costs. Their theory is that if a performance has been attained it can be attained again.

There is one additional thought; namely, the importance of having the basic data of a manufacturing enterprise maintained free from the fluctuating effects of wage levels and prices. For example, it is much sounder to have all of the performance records of a business expressed in terms of standard times per 100 units, units per man hour, units per machine hour, yield percentages, scrap percentages, and ratios such as the coke ratio in foundry practice. If the statistical data of a business are established in this manner much confusion is prevented and all costs, prices, and profits can be quickly and accurately adjusted to changing conditions.

IV. The Pricing Situation Which Will Result from the Resumption of Normal Peacetime Production

It is highly appropriate that some time be devoted at this meeting to a discussion of industrial pricing, particularly as it is affected by the present emergency and particularly as it influences the work of the certified public accountant. Our distinguished Secretary of the Treasury has stated that inflation has already begun. Moreover, we have been informed that the objectives of the present O.P.A.C.S. are three-fold: (1) to control the cost of defense facilities; (2) to maintain a proper equilibrium among the major divisions of our national economy; and (3) to fortify the people against the ravages of the deflation which will inevitably follow the present inflation.

I have just three observations to make on this subject of estimating and pricing techniques. The first is that present-day methods of management and accounting are still very inadequate to give our industrial executives the information they need both for the guidance of their separate corporations and for the coöperative regulation of the industries of which they are a part. The fact that we have these alternating periods of inflation and deflation and prosperity and depression is prima-facie evidence that the pricing of our industrial products is still very irrational and unscientific. To be specific, let me indicate the great divergence of methods of time study and labor cost control among our manufacturing corporations. Many companies conduct their cost accounting with one set of rates, their estimating with another set of rates, and their internal labor controls with still another set. I know an entire major industry which for the last fifteen years has been manufacturing certain sizes and types of products at a loss, which is still acknowledged by practically every manufacturer in the group. Our various industries operate with production unbalanced with consumption, with plant capacities unrelated to the market, and, above all else, with the prices of all of our goods and services determined not by the cost of production, but by uninformed competition, trial and error, or the blend of guesswork of marginal producers everywhere.

This fact that our pricing is still very irrational and unscientific leads to my second observation, namely, that the major cause of this condition is our failure to utilize in our cost accounting and estimating the fundamental principles of the science of statistics. I would define statistical science as that technique which has been developed by mathematicians for the classification, analysis, and interpretation of great aggregations of numbers, particularly by such devices as percentages, ratios, averages, medians, modes, index numbers, graphic charting, and correlations.

The salutary effects of the use of sound statistics and statistical methods can be found in the record of the legal reserve life-insurance companies throughout the years of the last depression. Here we have a titanic business with asset and income figures aggregating billions of dollars. During a period when many of our great banks, railroads, public utilities, and industrial corporations either failed or were compelled to recapitalize entirely, these life-insurance companies borrowed only a negligible amount from the R.F.C., loaned millions of dollars when all other enterprises were frantically trying to borrow, and emerged from the crisis with resources increased about $4,000,000,000 in four years.

Many theories have been given for this amazing record of stability. I shall give my own explanation, which I have formulated from interviews with life-insurance actuaries and from a somewhat extended analysis of the subject. I attribute the life-insurance record for solvency, stability, and growth to four fundamentals of management: (1) the calculation of all costs according to the most accurate and complete tables of facts in existence, viz., the American mortality tables; (2) the use of rates loaded accurately according to all classes of insurance risks; (3) the use of uniform calculations for interest income; and (4) complete interchange of all operating expense data annually. What the life-insurance industry virtually has, which is of interest to accountants, is a standard cost system which is observed by all of the leading "legal reserve" companies.

I have read with genuine interest the report of the American Institute of Accountants committee on accounting procedure recommending that accounting be defined as an art rather than as a science. If it is an art it will, as George Bailey has expressed it, "be subject to the necessity of proper observance of many fundamental practices, but leave room for other practices involving judgment, emphasis, and experience." What better tools can be utilized, by the industrial cost accountant, the corporation controller, or the certified public accountant than the techniques of our good friends the statisticians and also our good friends in the engineering profession?

My third observation on this subject of industrial pricing pertains to recent trends in business practices which are tending to minimize or to reduce the effects of competition as a factor in determining price levels. The first of these trends is, of course, the effect of the administration's price control policy as reflected through the O.P.A.C.S. This body has been able to establish "ceilings" in many industries and to delay if not to thwart many of the present-day tendencies toward inflation. A second trend is the growth in recent years of the trade association. I do not intimate here that our trade associations have been, in violation of federal statutes, price-fixing organizations; instead, I merely indicate that, through their national offices, they disseminate information regarding orders, sales, costs, and inventories. This has a beneficial effect on pricing policies. A third trend is the increase of state laws making sales below costs illegal under varying conditions. A fourth factor is the prevalance of "price leadership" in certain great industries whereby the leading producer dominates the field and the "independents" raise or lower their prices only when the "bellwether" corporation announces a change. A fifth trend is the development of the practice in leading industries of tacitly "sharing the market." Here again arrangements are not ultra vires but entirely within the law. When annual conventions are held among producers in the same industry there is a growing practice among the dominant personalities to survey the past year's apportionment of the sales, and, if profits have been adequate to "let well enough alone" and to advocate no price cutting if all are receiving "their share." A sixth trend is the development of competition through styles and services rather than through prices. In the automobile industry, for example, we are asked to inspect "all three" of the low priced cars being offered in the same price field and to make our selection on the basis of the conveniences, gadgets, style, etc., offered by each.

All of these tendencies indicate that the old order is changing not merely because of governmental interference from without but also because of new policies and practices operating from within. Nevertheless, it is my strong personal conviction that the controlling factor in pricing should still be some scientifically correct concept of cost, as exemplified by the policies of the life-insurance actuaries.

In concluding this summary of heterogeneous subjects I should like to avail myself of the privilege to submit a few words of endorsement and felicitation. As one who is lecturing regularly in a school of accountancy I should like to add my personal endorsement of the splendid work being done through your committees to elevate the educational requirements for admission to your profession, to exalt the standards of professional conduct, and to define the terminology of this new "art of accountancy." It is certainly indicative also of a broad vision and a realization of the responsibility of the hour that you have arranged this joint meeting with the National Association of Cost Accountants. If we are to make our American way of life truly free and truly democratic we must make it economically stable and sound as well. In this joint task we are happy and honored to collaborate with you.

V

Internal Operating Problems of an Accountant's Office

Chairman: J. N. AITKEN, JR. *September 17, 1941*

Introduction

BY J. N. AITKEN, JR., PHILADELPHIA, PA.
Member, American Institute of Accountants

THE general committee in arranging this session was very optimistic if it had in mind that *all* "internal operating problems of an accountant's office" could be uncovered and discussed in three hours.

Some of the minor problems—if they be problems—such as "How to Get Clients" and "How to Collect Bills" we will call "External Problems" and eliminate from this discussion other than to say that work well done does help in these respects.

But if this discussion will result in increasing your chargeable time to clients, we will consider it has been worth while.

Auditing is the main foundation upon which this profession is built. Practicing accountants recognize that this work of reviewing business transactions, and methods controlling and recording such transactions, must be performed by assistants to a large degree. The practicing accountant further recognizes that this work must be properly planned, supervised, and reviewed. Therefore, the purpose of this meeting is to discuss in a general way the men and the planning that are required to perform it.

Assuming that individual thinking is to endure—and I think that this is a fair assumption—the accounting profession needs raw material. It needs young men who have received a basic education in accounting and business matters; it needs young men who are of high moral character, honest in thinking, and determined in purpose. Considering present events and happenings, it needs these young men in increasing numbers to enable it to fulfill the job which will be its duty to assume.

The profession should see to it that it makes good use of such raw material, and that this raw material is properly fabricated into the finished product. During this period of fabrication it should lend all encouragement to those young men who evidently believe as we do that the scope of our profession is ever broadening, and it contains opportunities for them.

With the increase of responsibility which the profession is being asked to take, and with some regulation, we should see to it that our shop practice is maintained at a high rate of efficiency and improved. The planning department is just as important in successfully performing an audit engagement as it is in building a hundred thousand dollar machine. The maintenance of standards of work is just as necessary in performing an audit engagement as is the adherence to and the use of standards in manufacturing processes. There may be more deviations from a pre-arranged audit program than there would be deviations from the specifications of a well planned machine, but this is entirely as it should be, for the reason that the utilization of standards should reveal the points where the deviations should occur.

The planning should be such that it will facilitate the final inspection or review. While I do not subscribe to any idea that such a review would be based on the principle of "auditing the auditor," it is necessary that every reasonable precaution be taken.

One company in advertising its product says, "The priceless ingredient of every product is the honor and integrity of him who makes it." This is true of an examination from the standpoint of the personnel of the accounting organizations; and, therefore, it is fundamental that our raw material be good.

On October 24, 1940, the Administrator of the wage-and-hour law issued the regulations which set forth the status of all professional employees. Since that time practical problems have presented themselves, and undoubtedly a discussion of such problems would be beneficial to all of us.

It was thought well to split up the general topic of this session into four specific parts, and to have each part covered from a different angle. These parts are:

1. Formal audit program
2. Review of working papers
3. Staff training methods
4. Wages and hours

In each of the first three parts, an approach has been made from the angles of the larger practitioner and from the moderate-sized practitioner.

With respect to the fourth part, the wage-and-hour law, this will be discussed by counsel for the Institute, who will give us the latest information from Washington.

Formal Audit Programs as Applied to Internal Control

By Homer L. Dalton, Toledo, Ohio

Member, American Institute of Accountants

Formal audit programs as applied to internal control deal with the investigation of personnel, their interrelated duties, and the obtaining of specific information in connection therewith. In its broad sense, internal control comprehends all methods in use within a company's organization which tend to insure correctness and accuracy in its accounting records. Methods which involve a division of responsibility and the staff distribution of the work of the personnel tends to create a fear of discovery and in that respect it operates as an effective preventive of dishonesty.

There are those who are opposed to the employment of a prescribed program of audit on the grounds that it limits the responsibility of the accountant in charge, retards independent thinking, and creates a tendency to follow the line of least resistance. On the other hand, the absence of a formal audit program to determine the adequacy of internal control deprives the reviewer of the report of being assured that the field accountant has made certain specific investigations which he deems appropriate, of the personnel and their duties, and deprives the firm that is liable on the engagement from being assured that certain specific things have been done.

Developments in the past few years

have revealed that possibly too much emphasis has been placed on the fear that formal audit programs stint the imagination and resourcefulness and infringe upon the ingenuity of the field accountants. After all, the responsibility and accountability on an engagement is lodged with the signatory firm which should be protected by a clear, written record on a matter as important as a review of internal control. Paucity of data in the records relative to specific procedure employed in testing internal control probably has caused some of the accountants' troubles in the last few years.

The adoption of "Extensions of Auditing Procedure" and the paragraph in the model report dealing with the scope of the examination and reading in part: "We . . . have reviewed the system of internal control . . . to the extent we deemed appropriate" makes it mandatory that a definite program be employed in determining the adequacy of the system of internal control or check. The employment of the word "appropriate" indicates that a well planned survey has been made of the organization and the system of record keeping employed, and the record prepared must be a practical one which will stand up under any type of contest.

Because of the emphasis that is placed on internal control, accountants need very definite data in their files and something more than a purely narrative statement that internal control exists and is or is not ample. Since it is permissive for the accountant to give due weight to an internal system of audit regularly maintained by the use of auditors employed on the client's own staff, a thorough check must be made of the audit program employed by the client's internal auditors to ascertain its adequacy and to determine if it conforms to recognized auditing procedure. Any such survey is a continuous process, and effort must be expended to determine that what may appear to be an adequate plan of internal control on paper has failed of its purpose in actual practice.

Criticism and faults can be alleged of any formal audit program but time has demonstrated that the advantages accruing from the employment of such a plan outweigh the disadvantages. Some of the advantages of a formal audit program for determining the effectiveness of the procedures regarding internal control are that it:

a. Assures that field accountant has covered the minimum of points that the accounting firm deems appropriate in determining the adequacy of the internal control;
b. Establishes uniform standards for checking its adequacy;
c. Expedites subsequent review of audit papers;
d. Makes available complete uniform records as evidence that may be employed in case of a subsequent controversy as to the extent of the tests and investigation which the field auditor employed, which information becomes especially valuable when the field auditor is no longer on the staff of the auditing firm;
e. Avoids failure of field accountant to record what was done; and
f. Aids in determining the lines of evidence to be penetrated in making verifications of various phases of the financial statement.

Size and extent and content of a plan are said to be some of its disadvantages. These are not inherent disadvantages and the fundamental basic data that is to be obtained can be kept well within an extent and content consistent with the type and size of the engagement.

The design and content of a formal audit program as applied to internal control can be approached from various angles, but any such plan should be built around the four basic functions of business activities which may be briefly classified as follows:

a. Receiving, recording and, disposing of cash;

b. Disbursing of cash;
c. Purchase, receipt, and control of material, etc.;
d. Sale and delivery of products.

There are a multitude of other functions which are subsidiary to these four basic activities, and an audit program for determining the adequacy of internal control would comprehend various phases of these subactivities. The office practice of each firm of accountants will cause a variance in the methods of organizing and filing the working papers that pertain to the subject of internal control. It is suggested that a permanent work-paper file for each client be compiled which will be supplemented by data and notes taken from time to time as the audit progresses. This would constitute a continuous file to be reviewed each succeeding engagement.

There are numerous possible approaches to building the record in connection with a formal plan of testing internal control. Various names have been given to these approaches such as questionnaire, organization chart or other work-form charts. These plans have mutual objectives. The record to be built from the plan must be pliant and be susceptible of adjustment to conform to the peculiarities of each engagement. The data that it is obligatory for the field accountant to ascertain can be built into the plan with a considerable degree of brevity leaving latitude to the accountant for such supplementary information which his judgment dictates should be incorporated. In my opinion, a formal plan can be designed to incite rather than retard the auditor's accounting imagination.

Any formal program comprehends thorough investigation of the personnel and their interrelated duties. I recommend the plan which is a combination of what is often designated as the questionnaire and organization chart. This plan could be designed so that the duties and functions of the personnel are disclosed at the left-hand margin of the page appearing in vertical sequence and across the top of the page would appear the names of the personnel in horizontal sequence, a column appearing for each individual. A check mark can then be made in the individual columns opposite each duty or function that is recited. A quick perusal of the completed plan and a review of the intersection of lines and columns would readily divulge whether or not related functions become the duty of one individual or whether they are diversified. To illustrate, the plan would readily disclose whether the opening of the mail, the disposal of the day's receipts, the recording thereof, the posting to accounts receivable, and the disposing of the cash travel in sequence through a number of individuals or whether they fall under the supervision of a lesser number or one. As a consequence, considered judgment can be exercised in ascertaining whether collusion is imminent or remote.

The Utopian formal audit program will probably never be designed, but a plan incorporating the minimum of specific information required by signatory firms can be developed with flexible rules and procedures which will go far toward building a good written record in connection with this phase of the audit.

Formal Audit Program

By Fred J. Peterson, Des Moines, Iowa
Member, American Institute of Accountants

There seems to be an increasing amount of interest among accountants generally in the use of a formal audit program. Audit programs of various types have, of course, been used for a great many years by many accounting firms, but it is my impression that in the average case these have been used more or less as a guide only, and that little or no emphasis has been placed on the general form or make-up of the audit program and the proper use of same. Such changes as have been made over the past few years have, I believe, been due to the realization among accountants of the desirability of having a clear, concise picture of the detailed procedures followed in every case and just why these procedures were followed. Present-day problems, together with the ever increasing requirements of various governmental agencies, departments, and commissions, have to a large degree been instrumental in effecting many changes in auditing concepts and procedures during the past few years. Constantly too, there is need for additional information for use in special reports which are required to be filed by clients and for federal and state income-tax purposes, much, if not all, of which can best be developed during an audit. It seems desirable and timely, therefore, that in a session on internal operating problems of an accountant's office we give serious consideration to the question of methods and procedures whereby our objectives, whatever they may be in any given case, may be attained in a logical and orderly fashion. Much of the actual detail of an accountant's work in connection with the average audit engagement is not, or perhaps cannot in a practical way, be adequately reflected in the working papers, and it is quite possible, therefore, that a properly prepared and properly used detailed audit program can play an important part as recorded evidence of procedures followed and work performed.

This particular session is, I believe, primarily for the purpose of an exchange of ideas and experiences whereby we may all benefit, one from another. I thought it might be of some interest, therefore, instead of attempting to discuss the question of audit programs in general, to describe briefly and in a general way the client's permanent file and the detailed audit program in use as a part of the auditing procedure of an accounting firm of moderate size, having a number of branch offices, but where the final censorship, review, and typing of all audit reports is done at the central or home office. Under such operating conditions it is, of course, essential that the final reviewer have complete information in each case as to just what was done, why it was done, who performed the work, and the basis on which the character and extent of sampling and testing was determined. All of this must be described in the permanent file, the working papers, and the detailed audit program in such a manner and to such an extent that he can satisfy himself that the work performed represents an adequate and reasonable verification and constitutes a reasonable basis on which to arrive at an opinion.

The general procedures employed by this firm in connection with the handling of accounting or audit engagements is, I believe, much the same as in the average accounting firm, with the possible exception of final home-office review and in connection with the centralized typing department. All of the actual work in connection with the engagement, including preparation and development of the audit program, supervision, field work, and writing of the report, is done by the branch-office staff under the direction and supervision of the branch manager or resident partner. After completion of the field work, the usual procedures are also followed at the branch office in connection with review of the report, working papers, and permanent file. The report when sent to the home office along with the working papers and permanent file is, in effect, ready for typing. The management and staff of each branch is directly and entirely responsible for the performance of the work, the home office review being an added and entirely independent feature of the procedure. The central typing department logically follows as a matter of good office practice.

The working papers and permanent file, as well as the manuscript and a typed copy of the report, are returned to the branch office after the audit reports have been typed.

Permanent File

The use of a client's permanent file as a part of the complete audit program is worthy of some discussion. Such a file wherein is recorded, among other things, the results of the survey and study of the client's organization and procedures, becomes to a large extent the basis on which the detailed audit program is prepared. While the establishment and preparation of such a file necessarily represents a considerable amount of extra work on an initial or new engagement, it will if properly brought up to date and revised each year or audit period become increasingly valuable to the accountant in the conduct of his work and in the preparation of an audit routine. Following is a brief description of the general content and arrangement of the permanent file in use divided into sections and indexed somewhat as follows:

Corporate (or Other) Structure and Procedure

Under this heading are included copies of the articles of incorporation, by-laws and amendments, minutes, the record of the various capital-stock provisions, a running record of dividends declared on various classes of stock, copies of partnership agreements, trust indentures, wills, etc.

System and Internal Control

This section includes organization charts, lists of the personnel of the accounting departments and a comprehensive description of their duties, as well as a description of the accounting records in use. Explanatory charts showing the client's procedures and routine in connection with the handling of mail, purchases, inventories, cash receipts, sales and credit control, cash disbursements, etc., and samples of the important accounting forms, together with an explanation of the uses of these forms, are also included in this section of the file.

Financial Statements

Condensed comparative balance-sheets, profit-and-loss summaries, surplus statements, departmental gross-profit analyses, as well as other pertinent statistical data for as many years back as seems desirable under the existing circumstances, are included as a part of the permanent file. Such comparative statements, developed over a period of years, will afford the accountant a ready and effective means of watching and studying trends in the balance-sheet items as well as in the operating statements. Such information and knowledge is of decided importance in the proper preparation of an audit routine and for purposes of review in determining the adequacy of scope followed.

Property, Plant, and Equipment

In this section is kept a record of original purchases and additions, as well as a digest of appraisals, title reports or other evidences of title. Depreciation or exhaustion schedules are also included in this section.

Intangible Assets

This section includes pertinent facts in connection with patents, copyrights, franchises, formulas and designs, goodwill, etc.

Other divisions of the permanent file include insurance coverage, contracts in force, and conferences and important discussions. The latter constitutes notes of discussions held with attorneys, executives and others at various times on important or special phases of the work and which might have a bearing on future work or developments. A section is also included on taxes which is intended to indicate at all times the status of reports filed, not only for federal income taxes but state and other taxes as well.

The use of a proper index in connection with the permanent file adds much to its value. This index is printed on somewhat heavier paper than ordinary working paper so that it may be used for several years. A series of columns, each representing one year, are provided to the right of the indexed contents, which, by proper check mark or symbol, indicate the supervisor's or accountant's attention to each item each year.

Audit Program

The detailed audit program now in use contains eighteen or more pages, depending upon the number of bank accounts involved, the size of the engagement, and punched along the left-hand margin, to fit the working-paper covers. The first page of the audit program is for general information relative to the engagement such as period to be covered, nature of the service, starting and completion dates, special points involved, etc., as well as some general instructions to the accountant in charge. Significantly, the first of these instructions reads: "An examination of the client's system of internal control and the permanent file are to be completed before the audit routine is adopted." Each of the following pages in the audit program contain numbered and lettered instructions and procedures for some one or two account classifications. One page will cover the audit of cash, one covers accounts receivable, another inventories, and so on. A separate page is used for each bank account except where these might be too numerous, in which case an especially prepared columnar sheet is inserted indicating the procedures to be followed on each account. In addition to the printed procedures on each page, blank spaces or lines are provided for insertion of additional instructions or procedures which may be deemed necessary or desirable for the particular case at hand. To the left of the printed instructions on each page, in a space of about two inches, are a series of narrow columns, numbered one to twelve, indicating the months of the year. Two additional columns, one for the initials of the accountant performing each particular operation and the other for the time or man-hours consumed, are also provided.

The actual preparation of the audit program proceeds to a large extent simultaneously with performance of the examination. The program must be kept flexible to allow for expansion or modification depending upon conditions as they arise and determination of extent and character of sampling and testing deemed necessary and reasonable. At the start of an audit engagement, the supervisor or principal usually indicates by special symbol in front of the routine number only such operations as are usual in every audit. As his survey and study of the client's system of internal control proceeds, the audit routine or program is further developed. Check marks or symbols are placed in front of the routine number and at the top of month space for each of the months to be audited. Thus, as an example, in the audit of cash, the supervisor might indicate by check marks opposite the routine numbers that the petty cash funds are to be counted, listed, and reconciled to the closing date and that perhaps petty cash disbursements are to be checked in detail for three months, say April, September, and December. The same type of procedure would follow throughout the remainder of the cash items as well as throughout the entire program or routine. As the various operations and procedures are completed, the assistants indicate completion by appropriate check marks directly under the symbols or check marks made by the supervisor and initial the specific operation in the space provided. The accountant in charge of the engagement is responsible for the assignment of work among his assistants and it is his duty to see that the audit program is properly used and checked as the audit proceeds. Any important questions as to the scope of the work which, in his opinion, should be changed are, of course, taken up and discussed with the supervisor or principal.

Working Papers

Preparation and arrangement of the working papers as a part of the entire audit program and procedure also deserves some comment. I need not go into the question of content or general form of working papers except to point out that these should tie up directly with the detailed audit program and the permanent file and should reflect the results of the procedures and details indicated in the audit program as having been performed. Each schedule, analysis, and summary, in fact every supporting working paper, should tie in with the working trial balance and should bear the name or initials of the accountant performing that part of the work, as well as the date work was performed. The audit program, each page and each item of which is numbered or lettered, becomes a part of the working-paper file when completed and provides the basis for an excellent method of indexing the working papers.

Picture now, if you will, the completed job ready for final review and typing of the report. First of all, there is a permanent file brought up to date in every detail. This includes a record of the client's organization and procedures, the authority under which it works as granted to it in a charter, and the delegation of this authority by means of by-laws; directors' resolutions, etc. It includes a record of executive and accounting personnel, the duties and functions of each, and how these functions tie in and dovetail with the functions of others. From this information has been determined, to a large extent, the system of internal control. The effectiveness of the system of internal check and control has been checked by means of adequate sampling and testing. Next there is the detailed audit program and the working papers. These indicate just what procedures were followed and the extent and character of the sampling and testing. By careful analysis and study of the contents of the permanent file, the reviewer is in a position to determine independently the adequacy of the program followed and the basis on which the auditor's opinion was arrived at.

Summary

As a summary, it might be well to note some of the advantages and, on the other hand, limitations to be found in the use of a formal audit program. While essentially a planned procedure of an audit engagement and a guide to the accountants performing the work, an audit program cannot be predetermined at the outset of an engagement. It must necessarily be flexible and should not in any way interfere with, or take the place of, the independent thinking, judgment, or initiative of the accountant in charge or his assistants. It must be based on a thorough knowledge of the client's system of internal control. It should be prepared and used in such a manner that when the work is completed, it is a complete and permanent record, supported by adequate working papers, of all the details and procedures followed and by whom the work was done. It must be directly tied up with the detailed working papers and with the permanent file. It can be used as a guide in the preparation of the program in a succeeding audit. It must be properly used by the staff accountants whereby each operation is checked as completed. In this way, it can serve as an indicator of the day-by-day progress of the work to the accountant in charge and to the supervisor.

In concluding, I do not wish to leave the impression that the methods and procedures described above are considered as the ultimate or that perfection has been reached.

On the contrary, refinements and improvements are constantly being sought, and it is hoped that this very general presentation will afford some points for discussion out of which we may all derive something of benefit to help us in connection with the ever increasing problems in an accountant's office.

Review of Working Papers from the Viewpoint of the Moderate Sized Accounting Firm

BY JAMES A. RENNIE, RICHMOND, VA.
Member, American Institute of Accountants

THE same objectives are involved in the review of audit working papers whether the firm be large, medium, or small.

These objectives may be consolidated in one question: Do the working papers furnish the evidence of a solid foundation for the report which has been prepared therefrom? The answer is important because the report is the standard by which the firm is judged; hence, it may enhance or injure a firm's reputation. Nothing can be more embarrassing or injurious to a firm than to see its seemingly complete report collapse for want of a sound foundation.

The cause of the collapse may not be revealed by the working papers, as they are but affirmative evidence of part of the field work. They may not reflect errors of judgment, failure to investigate matters that should have been investigated, or disclose lack of integrity on the part of the firm's employees.

Competency and integrity of employees are not qualities to be investigated with each engagement; that the employee possesses them should be believed by any reputable firm before entrusting its reputation in the employee's hands, and grounds for the belief should be founded on investigation before employment and on observation of work and conduct while employed.

Granted that working papers are not a perfect medium to reveal all the facts of an audit, yet they constitute the only tangible evidence to support the report by which a firm member in reviewing it in the office can appraise the adequacy of the work upon which the report is founded. Unquestionably, complete work papers analytically reviewed by a seasoned accountant help materially in reducing the possibilities of errors and deficiencies of a report.

The Securities and Exchange Commission in its report on the *Interstate Hosiery Mills* case has the following to say about the review of working papers:

"We think it is self-evident that the review upon which an accounting firm assumes responsibility for work done by subordinates must be more than a series of perfunctory questions as to the performance of particular items in an audit report. Nor should explanations of unusual items be accepted by a reviewer without support in detail from the working papers. As a matter of principle, a review should, it seems to us, be designed with two objectives in mind:

First, to insure the integration of the original work papers with the financial statements; second, a searching analysis of the ultimate facts developed in the course of the actual audit. An adequate review with the first purpose in mind should serve not only to disclose intentional or accidental misstatements but should also serve as a method of internal check and control on the work of the firm's subordinates. This branch of the review, it seems to us, need not necessarily be carried out by a partner but should at least be done by one well versed in the procedures adopted by the firm and in the general principles and terminology of auditing and accounting. If not a partner of the firm, such review should, in our opinion, be made by persons who are independent of those actually performing or supervising the audit work as well as of those who prepared the draft of the financial statements. The second branch of the review is designed to enable the accounting firm to interpret intelligently the figures it has obtained and to which it is to certify. This part of the review should, it seems to us, be made by a person, preferably a partner, qualified by his knowledge of sound accounting principles and his familiarity with the accounting phases of the industry and the more important problems of the particular company. In this manner the facts ascertained by competent employees can be subjected to the independent and broader judgment of a more experienced person who can by searching inquiry of the supervisor or senior and by examination of significant items in the work papers and schedules reach an informed judgment both as to the adequacy of the audit work done and as to the integrity and clarity of the financial statements themselves. We are satisfied that a review along these lines would have exposed the irregularities in this case."

Here is a case where a trusted senior accountant of ten years' service betrayed his trust and involved his employers in an embarrassing and perhaps costly procedure. The record shows that the firm had every reason to impose its trust in this employee, as he had been highly recommended before employment and his services before the instant case had been rendered in a competent and conscientious manner.

As implied in the preceding quotation from the report of the Securities and Exchange Commission, the Commission considered the review of the report inadequate. They also said that the record failed to show that the review was less extensive than that ordinarily made by accounting firms. Following this statement, they made the following observation:

"However, if we accept the view of these expert witnesses as to the usual practice followed by independent public accountants in reviewing the work of those responsible for the actual carrying out of audit procedures, in our opinion the practice requires thorough revision."

No description has been given of the methods used in reviewing the report, but reference has been made in the previous paragraph that they were not less extensive than those ordinarily made by accounting firms. A very material fact to consider is that the reviewer was dealing with a false work-sheet trial balance, as one page of the original trial balance was replaced by a page containing account amounts that agreed with the account amounts in the report. Whenever a staff member regarded as highly competent and trustworthy deliberately sets about to deceive his employers by rigging false work papers, detection of his malfeasance requires almost an audit of the auditor. In other words, faith will have to be dispensed with in the review. But faith cannot be dispensed with in certain field procedures of an audit which are not revealed by working papers.

Accounting firms, I feel sure, welcome the suggestions of the Securities and Exchange Commission on how to make the review of working papers more effective, as they are the ones who have great stakes at interest. No doubt the suggestions will have the effect of obtaining a more critical review of working papers, and it is for this reason that the *Interstate Hosiery Mills* case has been introduced in this paper. But conceding that all of the recommendations made by the Commission in this respect are carried out, there will always remain dependence upon the intangible human qualities of judgment and conscientiousness. How to blend best the tangible and intangible is an ever present problem with accounting firms, regardless of size.

Medium-sized firms that have been in practice for many years have an advantage over the larger firms in appraising the intangible qualities of staff members. The reason for this, based on long observation of firms in this area, is the small turnover of staff. In the majority of these firms, senior accountants started as juniors with the same firm and firm members did likewise. Through many years of working together, there is a bond of personal interest between firm and staff whereby the way is eased for a discussion and possibly a solution of personal matters which might cause a let-down in moral standards. When these standards start to disintegrate, the firm had better watch out, because every staff member is a custodian of the firm's reputation and one man can do much to tear down what has taken many years to build. Another advantage derived from long association is a greater knowledge of technical abilities of staff members and their fitness for particular types of work. These advantages, however, may turn into disabilities if too much is taken for granted when reviewing the work of those favorably known to the reviewer.

As a firm grows in size, it realizes the need for more formalized and standard procedures in preparing working papers, arrangement of subject matter in a report, and the review of report. Anyone who has grown up with a firm of small beginnings can look back to the time when each staff member had his own way of filing working papers, made his own determination of what was necessary to be included therein, and prepared a report according to his own ideas within the uncertain boundaries of report arrangement and terminology generally adopted by the firm. Partners were no different from the staff in this respect. In fact, the staff merely copied the practices of the partners. Under such practices, the reviewing of reports could not extend beyond a reading of them and checking of subsidiary statements with main statements. Viewed retrospectively, the methods of those days resemble the practice of several independent practitioners who occupy the same office.

The growing recognition by business and governmental agencies in recent years of the value of accounting services has placed upon the practicing accountant added responsibilities. Much more is expected of him today than was even remotely considered his function a few years ago. With the added demands the accountant has found it necessary to develop new methods to safeguard his reports and, what is equally important, the reputation he has acquired so conscientiously and so laboriously over a period of years. Still far from satisfactory to the accountant, and certainly far from perfect, are procedures being tested daily to the end that those unfortunate instances, which occur but seldom, but of which we hear so much, may be controlled and further repetition avoided. What are we not now doing that we should do?

That is not the exclusive problem of the small compact organization, nor of the firm of medium size, nor yet of those large organizations with widely scattered offices; it is general in its application. Each enjoys certain advantages, each has its own particular difficulties in coping with the problem, so that no common solution is to be expected. It is the problem of all alike to persevere in the effort to improve present practices, and suggestions like those hereinbefore quoted from the report of the Securities and Exchange Commission are helpful and welcome.

Review of working papers is an important part of the problem. Each firm, regardless of size, has its own methods, but there are certain requirements which are fundamental for a proper review. Obviously, the papers should be complete in all essentials. Next in importance, they should be arranged in an orderly fashion and indexed to provide ready reference in checking supporting schedules to the work-sheet trial balance. And whenever possible, they should be given at least a preliminary review by a supervisor or partner familiar with the particular type of business at hand. Given proper supporting data, the reviewer must bring into play his general ability and special experience to judge the adequacy of the examination as the basis for the report to which the firm places its certificate.

Assuming equal technical ability, the reviewer's personality can add to or detract from the effectiveness of the review. One with a caustic tongue and frowning countenance is likely to cause the accountant whose work is under scrutiny to assume a guarded, defensive attitude, which is not conducive to the development of obscure information that may have a determining effect upon the value of the work. On the other hand, judiciously phrased questions, seeking information rather than finding fault, often serve to bring out valuable sidelights of immense benefit to both the reviewer and the accountant. You have all, no doubt, observed the different attitude of witnesses under direct examination and cross examination—cooperation and development of the subject versus restraint, reluctance, and, perhaps, mental antagonism. The results obtained in each instance are so obvious that it is unnecessary to add that I subscribe to the direct examination method.

There are, then, four major points which the reviewer must keep constantly in mind: (1) he must have confidence, based on his observation, in the accountant's integrity and ability; (2) he must have adequate supporting data in orderly arrangement; (3) he must have special knowledge of the particular subject or have available for conference associates who are familiar with the business under review; and (4) he must approach his task with a view to developing the utmost possibilities of the engagement. All these points are essential and interdependent and on them, to the extent that they are observed, depends the effectiveness of the reviewer's work.

Partner's Review of Working Papers

BY FRANK G. SHORT, SAN FRANCISCO, CALIF.
Member, American Institute of Accountants

I

NO DISCUSSION of our subject would be complete without a consideration of the findings and opinion of the Securities and Exchange Commission in the matter of *Interstate Hosiery Mills, Inc.*, for, so far as I know, this is the leading case in which the question of review of working papers has arisen. The evidence amply supported the finding that Homes & Davis, certified public accountants, certified to financial statements of Interstate which were false in that certain of the assets and the profits were overstated in material amounts. The evidence also clearly indicates that this certification was not deliberate in so far as Homes & Davis were concerned. Rather, that firm was the victim of a most unusual set of circumstances involving the apparently motiveless dishonesty of a trusted employee.

The employee in question, one Marien, was the accountant in charge of the Interstate examination. He deliberately incorporated the false amounts in the report and apparently altered the working papers to support them. In its findings, the Commission states that ". . . there was no evidence of complicity with Marien by any of the officers, directors, or employees of Interstate, or by any partners or employees of Homes & Davis. . . ." The only explanation given of Marien's action appears in the following quotation:

"A deputation called upon Marien at his home that night in an effort to obtain an explanation but Marien would say only that he must have been crazy, that he received nothing for what he had done, and he did not know why he had done it."

Nor does it appear that the accounting firm was in any way delinquent in delegating to Marien the responsibility for an engagement of this character. He was not a member of the American Institute of Accountants nor does it appear that he was a certified public accountant. However, when he was employed by Homes & Davis, that firm made reasonable investigation of his background and found that he had an excellent education and eight years of public accounting experience, all with a single firm. He was highly recommended by his former employers. He appears to have been thoroughly tested under supervision by Homes & Davis before being given charge of important work, and he had in fact been in the employ of Homes & Davis for approximately seven years (making fifteen years in public accountancy) before the first falsification of the Interstate report occurred. With such a record one is compelled, in the absence of any other explanation, to accept Marien's statement that he "must have been crazy." The Commission itself expressed the opinion that "Under all the circumstances, we do not think that Homes & Davis can fairly be charged with negligence in employing and training Marien for the work he did."

During the engagement Marien used from fourteen to sixteen assistants, of whom five or six were seniors. To anyone familiar with auditing, where a staff of this size is involved, it is apparent that the accountant in charge will have little of his own time available for direct audit work. He may personally handle certain phases of the work which he regards as of unusual importance. Predominantly, however, his time will be devoted to the instruction of his assistants and to assembling and reviewing their work sheets. Thus the accountant in charge of such an engagement is himself spending most of his time reviewing the voluminous results which would be developed by a staff of the size indicated. Moreover, responsibility for such an engagement would not be delegated by any intelligent principal except to an accountant of ability and integrity comparable to that of the principal himself. The findings of the Commission clearly indicate that Homes & Davis were warranted in considering Marien to be an accountant possessing these qualifications.

When Marien had completed his work, he submitted his draft report and working papers to a partner for final approval. The partner's review of the work consisted of reading the report and asking Marien a series of questions regarding the scope of the work and its results, accompanied by an occasional dipping into the working papers, but he made no thorough check of the latter. The Commission is rather critical of this method of review and there is no question that to a layman it must seem rather casual. However, principals of long experience have found it adequate where the accountant in charge is a man of ability and integrity. The discussion which arises from the apparently random questioning will normally bring out any controversial points. Two independent public accountants gave expert testimony that they considered the method adequate under the circumstances.

The findings of fact which I have discussed obviously warrant the conclusion that when an accountant, or any other person, in a key position becomes insane without the knowledge of his associates, almost anything is apt to happen and, in my judgment, they warrant no further conclusion. The Commission, however, is able to use the same facts to arrive at the rather astonishing opinion that our reviewing "practice requires thorough revision" (although there is no showing whatever that it is inadequate under normal circumstances). It then proceeds to describe the type of review—or rather, two separate reviews—which it considers necessary. If such an opinion were expressed in a court of law, it would be precisely worthless, because it is not based upon the evidence. Moreover, and quite naturally in view of the circumstances, the reviewing process which the Commission advocates is woefully lacking in realism. Under these circumstances, I do not think we need take the opinion too seriously. After all, while I have noticed that many accountants tend to become a little queer after fifteen years in public accountancy, only a very small proportion of us become insane.

II

It is not possible to express my opinion as to the type of review which should be made without first discussing the relationship of the review operation to the broad question of how the principal may control the quality of auditing when performed by assistants. In doing this, I must encroach briefly upon the field of other speakers.

It is apparent that the principal incurs a risk of money damages in connection with every audit which he or his partners undertake. These are insurable risks, however, and most of the larger firms do insure against them. Let us clearly distinguish between such insurable risks and another obligation, moral in character, to our fellow practitioners, to the general public, and to our clients. I refer to the fact that every accountant has an obligation to do the best work of which he is capable. The actual results of such "best work" will, of course, vary, for naturally no two accountants have precisely similar skill and judgment. I submit that the manner in which any principal meets this moral obligation must essentially be a matter for his individual judgment and that the methods used will vary according to the local conditions peculiar to different offices.

Since the review of working papers and reports is merely one of the methods by which a principal seeks to control the excellence of the work for which he is responsible, it follows that it will receive more emphasis in some offices than it does in others. In some offices more effective means of control may be in force and in these offices the review procedure will have been reduced to a relatively unimportant status. In other offices, the review procedure represents practically the only method of control and in such unsatisfactory cases it must receive great emphasis. I shall discuss later methods of control which I personally regard as ideal, and the relationship of review to these methods. Pending the general adoption of these or superior methods, the extent of the review procedure must, in line with the thoughts previously expressed, remain a matter for the discretion of the individual principal.

If major reliance is to be placed upon reviews for the control of audit work, they would necessarily have to be quite elaborate, each of them would take a good deal of time and, probably, the principal himself should make them. Since most audit work reaches its culmination during the busy season following December 31st, it seems obvious that an impossible situation would be created. No principal has the time during these busy months to make personally such extensive reviews. No, if only upon considerations of practicability, we cannot rely upon reviews as the major method of controlling audit work.

A few months ago I sent one of my assistants from my office in San Francisco to Alaska to make an audit, the report upon which was required by a specified date. The traveling time to his destination and return was two weeks, a very substantial proportion of the total time allowed us for the work. Suppose I had depended solely upon review as a method of control, would I not have been in a rather absurd situation had I discovered some inadequacy in the work as a result of review? In less exaggerated form, similar conditions apply in the case of all out-of-town engagements. No principal who wishes to preserve reasonable "face" can send men back to the field to complete work which should have been done in the first instance. Means must be found to insure that audit work is competently done before it arrives at the point of review. In other words, preview is much more important than review. Also, I submit, if the preview has been properly handled then the review becomes of relatively minor importance.

No doubt I could if necessary supply other reasons to prove my point that review in itself does not constitute a satisfactory method of control. I think I have also supported my statement that the S.E.C.'s opinion in the Interstate matter, which placed great emphasis upon the necessity of most elaborate reviews, is lacking in realism. Do not, however, think that, because I disagree both with the method and the conclusion of the S.E.C. in this case, I believe that our present typical methods of control are adequate. I most emphatically do not. Before discussing this point, I wish to make it clear that I do not consider it possible for the profession as a whole generally to attain in the immediate future the standards I advocate. We are facing a serious shortage of man power, and indeed many of us are already experiencing its effects. We will have difficulty enough maintaining our present standards during the next few years without attempting to raise these standards. Thus, my comments should be regarded as representing my conception of a goal to be aimed at rather than standards which are capable of immediate adoption.

Control of audit work naturally falls into five phases, as follows:

1. Selection of clients.

2. Selection of staff.
3. Planning the work.
4. Performing the work.
5. Reviewing the work.

A conscientious principal will seek to commence his control of audit work at the point where he accepts a new client. The responsibilities which fall upon auditors in these days are onerous enough without adding to them by accepting as clients those of poor repute. Consequently, we should develop better methods of investigating proposed new clients before they are accepted. Of course, there are no methods available to us which will reveal that the president of a company had previously been convicted of a felony under another name. Nevertheless, reasonable investigation will minimize the risk of our accepting dishonest persons as clients.

The conscientious principal will also regard every applicant for employment on his staff as a potential qualified member of the profession. The principal should, therefore, by every reasonable means, seek to ascertain that the applicant has such character and education as will tend to make him a credit to the profession. Of course, no investigation will absolutely preclude our occasionally employing men who do not meet our standards of character. Consequently, every new staff member should for a reasonable period work under such conditions as will insure the elimination of those of indifferent character.

It is in the planning of the work that the principal has his greatest opportunity to exercise with effective results his presumably greater experience and skill. In my judgment, the principal himself should take an active part in the development of the audit program and he should do this work in the client's office, in conjunction with the accountant in charge, where he may have close contact with the conditions which must be adequately covered by the program. He should, in my opinion, spend a substantial amount of time in the preparation of each program, enough certainly that he feels he has done the best job of which he is capable. In addition to being the most effective point at which the personal skill and experience of the principal may be exercised, the development of programs represents a phase of the work which the principal can reasonably be expected to perform. In most cases, programs need not be developed during that hectic period which follows December 31st, but can, and to get the best results should, be prepared during the remaining period of the year when the principal has sufficient leisure to make an intensive study of the engagement. Programs, in my judgment, should never be so drawn that they have a tendency to restrict the accountant in charge of the performance of the work. Rather, they should be so drafted as to invite the accountant in charge to follow up any line of inquiry which he deems advisable.

It is apparent, I think, that no matter how much care may be given to planning and reviewing, no audit can be competently performed unless the accountant in charge is himself competent. He should, I think, be a certified public accountant, or one with equivalent qualifications, and he should be of the type to keep himself familiar with accounting literature, including the publications of the American Institute and of the S.E.C. Naturally, he should be of such character as to be immune from improper approach by the client's officers or employees. It follows, therefore, that he should have been with the firm for a sufficient length of time to have been tested for both ability and character. By accountant in charge, I mean the man who has active charge of the work in the field. No amount of office supervision can make up for lack of ability or character in this man. On very small engagements, an accountant may, conceivably, take charge of two concurrent engagements by spending half of his time on each. Generally speaking, however, the accountant in charge will be continuously in the client's office during the entire course of the engagement. Assistants to the accountant in charge may be of lesser ability and in reasonable proportions, consistent with the character of the work, they could be temporary men.

Audits made under the foregoing conditions, in my judgment, require little review. Care has been used in the selection of clients and staff. The principal has given his own personal time to the most important phase of the work and no responsibility has been delegated except to accountants of proved skill and character. Nevertheless, some review is necessary and, in the remainder of this paper, I shall return to my subject and discuss the character of the review which I conceive to be necessary.

III

Let me say to begin with that, under the conditions which I have described, I do not think that our reviews should contemplate the possibility of dishonesty upon the part of the accountant in charge. The S.E.C., in its opinion in the Interstate case, infers that this is one of the objectives in the review of working papers. It is true that in this case the dishonesty might have been discovered by a meticulous review of the working papers, but remember the dishonest accountant was insane. I think we will all agree that a dishonest, but sane, accountant in charge would be quite capable of preparing working papers so that his fraud could never be discovered from them. If he does not have this much skill, he should never have been an accountant in charge in the first instance. Moreover, dishonesty is relatively rare in the profession. It is true occasional instances of it may arise, but these should be regarded as unfortunate accidents, to which we are all subject, and they should involve no professional discredit to a principal who has used reasonable care in the selection and testing of his assistants.

Upon the completion of the draft report there should, in my opinion, be a review of the working papers in conjunction with the draft report. In large offices this review would probably be made by a reviewer, who does nothing else, and in smaller offices it should be made by any available man possessing the qualifications of an accountant in charge. The review will really be more effective if done by such men than if done by the principal himself, in view of the constant interruptions to which the average principal is subject. The review should be of relatively limited character, but thorough enough to cover the following points:

1. So far as can be judged from the working papers, has a thorough job been done? Has the accountant in charge felt it necessary to do any additional work not called for by the program? Is the program still adequate? If there is any feeling, on the part of either the accountant in charge or the reviewer, that it is not, then the matter should be discussed with the principal.
2. Has the accountant in charge made any mathematical errors? This phase of the work does not call for a complete checking of the mathematics of the entire working papers. Men who are competent to be accountants in charge should know how to construct working papers which are largely self-checking. Nevertheless, there is always the remote possibility of such an error as the incorrect posting of an adjustment entry.
3. Are there any points which involve possible differences of opinion as to the proper accounting treatment? If any such points arise, they should be settled immediately by conference between the accountant in charge, the reviewer and the principal, and a full explanation of the reasons for the treatment decided upon should be made in the working papers.

4. Are the working papers sufficiently explanatory? I have noticed that many able accountants tend to make extremely sketchy working papers. The reviewer, in guarding against this tendency, might well contemplate the possibility of the working papers being introduced in court at a later date when the accountant in charge would not be available to supplement them by oral testimony.

After the working papers and draft report have been reviewed, the latter should come to the principal to be read before typing. The principal should read the report carefully in the light of the knowledge he gained at the time he prepared the original program and such other knowledge applicable to the engagement as he may possess. As a result of this reading he may desire to discuss phases of the work with the accountant in charge, the reviewer, or both. The principal will also, undoubtedly, wish to have the previous year's report in front of him for purposes of comparison and, in this connection, I have found the easily acquired art of using a slide rule very advantageous. In many cases, the principal will desire to make some changes in the draft report. Most of these will be simple changes in English, which improve the construction without altering the sense of the report. I personally never make any alterations other than these without conference with the accountant in charge and the reviewer.

After the report has been typed, the typed copy should be put through a well planned checking operation. I shall not discuss this phase of the work in detail, since it is at the present time generally well handled. I mention it merely because in part (e.g., referencing) it constitutes a phase of the review, performed as a matter of expediency after the typing operation has been completed.

IV

To conclude. The principal has an obligation to do his best to see that audit work is well done. In the course of doing this, he may properly delegate work to others whom he considers competent. This delegation, however, must not be carried to such an extent that the principal gives nothing of his own experience and ability to the engagement, nor should work be delegated to others without due care or without reasonable controls. While review of working papers is necessary as one of the controls, it is not necessary that it be performed by the principal himself or that it be unduly extensive. The principal can make his greatest contribution to the quality of the audit by using his time for preview rather than review, in other words, in the planning of the work.

Staff Training Methods from the Viewpoint of the Larger Practitioner

BY RAYMOND G. ANKERS, NEW YORK

Member, American Institute of Accountants

IT WAS with some mental reservation that I set out to prepare a paper regarding staff training methods from the viewpoint of the larger practitioners, inasmuch as most of these firms have given considerable thought to this subject and have arrived at a solution which best fits their own personnel situation. It was pointed out that this subject is growing in importance and receiving more general attention, and that a comprehensive review of the subject may bring out some points worthy of further consideration.

It seems to me that there are two separate and distinct phases of staff training:

1. The training of beginners before they are assigned to staff work, and
2. The training or guidance of staff members.

Both of these, I am convinced, are important.

With respect to the training of beginners, let us first consider how they are selected and why staff training, as a prelude to staff work, is vital to their rapid development. The larger firms usually recruit beginners from the most recent graduating classes of colleges or schools of business administration. The students selected are generally those who have majored in accounting and who have an educational background adequate to meet the C.P.A. laws and regulations of any state in the Union. In most instances, they have had no previous business experience, their selection being based solely upon personality, appearance, and scholastic standing.

As to scholastic standing, I would like to quote Dean Tippetts of the School of Business Administration, University of Pittsburgh. He made this observation at the twenty-second annual meeting of the American Association of Collegiate Schools of Business during a discussion of placement problems faced by universities. It indicates that a high scholastic standing is deemed more important in filling positions in the accounting field than in other fields. I quote:

"We find that our employers are not so much interested in grades as they are in whether or not this student was active on the campus. If this student was a leader on the campus they became very much interested in him and looked at his appearance and personality, and, I think, his grades are about the last thing they look at. If he is in the upper 50 per cent of his class that seems to be about all that most of them require, *except for the accounting positions; there they seem to want good grades.*"

If the men selected by public accounting firms have this high scholastic standing you may question why they require training. Is their lack of previous business experience the sole reason? I do not think so. Granted that the lack of business experience alone justifies a training period, there are several other factors equally important. Let me enumerate a few of them.

In the first place, we cannot overlook the peculiar nature of professional accounting work. There is a marked contrast between the beginner in the corporate field where he is known by his associates as a beginner and allowance is made for inexperience, and the beginner in the public accounting field where he is not usually introduced as a raw junior and yet may have numerous contacts with clients' employees. Furthermore, men assigned to work in offices of clients are considered (at least by the layman) as experts. And then, too, since clients pay fairly substantial fees for services rendered by staff accountants, they expect trained men to handle their work.

A training period affords an opportunity to impress upon beginners the responsibility they assume as staff members of a public accounting firm. In most cases they fail to realize the full significance of their new position and the importance which attaches to even the routine work to which they are assigned.

Have you not also noticed that beginners lack appreciation for accuracy not only in figures but also in speech and writing? Although we cannot change this attitude over night, we can go a long way toward correcting it during a training period of reasonable length.

Another reason for staff training,

which is definitely not the least important, is the deficiency on the part of most beginners in auditing theory. They are not familiar with even the elementary procedures followed by public accountants on audit engagements. The colleges give them an excellent background in accounting, but not in auditing. Seeking to determine the reason for this, I find that most colleges offer only 4 to 6 points in auditing subjects while 20 or more points are offered in accounting subjects. Obviously, the student must know accounting before he is in a position to study auditing and probably more time should be spent teaching accounting than teaching auditing. Nevertheless, I believe additional auditing courses are more essential to the young man entering public accounting than courses in specialized fields such as insurance accounting, brokerage accounting, or even income-tax work. Yet the 20 points of accounting previously mentioned include a number of courses of this specialized character. Might it not be helpful if the colleges rearranged their curricula so as to include more auditing courses for those students who expect to enter professional accounting? At the present time graduate work at one of the larger universities seems to be the only solution. These remarks should nowise be construed as a criticism of the colleges. The colleges have done a remarkable job in keeping abreast with the demands of the rapidly growing profession of accountancy. Without doubt, they are constantly striving to better fit students for their life work and are receptive to suggestions from the business and professional world. If the students are not receiving adequate auditing courses in the colleges, probably the responsibility is at least partly our own for not pointing out to the colleges this deficiency in their curricula. Would it not be a good idea for a committee of the American Institute to confer with the deans of schools of business administration with reference to this matter?

Now that we have touched upon some of the reasons for a preliminary training course and upon the type of men being employed as beginners, let us review the training methods followed by the larger firms. The methods, for the purpose of this discussion, may be grouped under two general headings:

1. The intensive-training method.
2. The report-department method.

The intensive-training method contemplates a period of instruction lasting from one to three months. For example, last summer one nation-wide firm had all the beginners from its several offices throughout the country report to the main office for a month of intensive training. In the heat of the summer the students obtained a taste of what they could look forward to as staff members. It may be noted that although the course was carefully planned and adequate instructors were available, the students put in many hours of overtime to complete the course on the scheduled date and in a satisfactory manner. This overtime was due largely to the desire on the part of the students themselves to get all the training possible within the allotted time.

Let me outline for you an intensive training course requiring approximately two months. Conducting it will be a full-time job for a well qualified accountant able to retain the continued respect and confidence of the beginners, or students as they are sometimes called. The course I have in mind includes an audit set, the working of problems, use of accounting machines, lectures by partners and supervisors, and talks by students.

The audit set is used as the foundation upon which to build a course covering the practical aspects of the work of the public accountant. The work required by the set alone is beneficial to the students and their progress throughout is followed closely by the instructor. But the lectures, given in conjunction with the set by the instructor, by partners, or by supervisors prove to be of greatest value. For example, when the beginners are doing the cash work as provided in the set, actual cash examinations made for various clients are explained to them. Working papers are used to illustrate the points brought out by the lecturer and are made available for the students to peruse. In this way, the student not only obtains a broad conception of a cash audit but also learns how to prepare audit working papers. As indicated, these lectures are given on each item appearing on the balance-sheet and income statement.

In addition to these lectures, beginners are given pointers as to how juniors should conduct themselves in the office of a client, what their contacts and relationships with clients and clients' employees should be, and information concerning the history, the office methods, and procedures of the firm. They also receive instruction relating to audit work in specialized fields, such as brokerage, public utilities, banking, importing, and exporting, etc.

Aside from the audit set and lectures, at least an hour is devoted each day to working problems. Although these problems are varied, the students should receive a good many in simple addition; that is, footing and cross-footing columns of figures. For this purpose, mimeograph examples can be prepared and the same example used more than once. To stimulate interest in this work, the students are asked to keep track of the time it takes to complete each problem. When the problem is submitted a second time a few weeks later they are agreeably surprised to find that they have become more rapid in this work.

Occasionally questions which appeared on previous C.P.A. examinations and American Institute examinations are given to the students. The wise instructor selects questions for which model solutions appeared in *The Journal of Accountancy* or are published in book form.

In order to improve the students' knowledge of the written and spoken word, they are required to give talks of approximately ten minutes in length at least once each week. In some instances, papers are prepared and submitted to the instructor for review and approval before they are read to the class. In other cases they talk from an outline, while in still others a topic is assigned and they are asked to talk extemporaneously. Naturally an advantage accrues if these talks are on accounting subjects because of the research necessary to prepare them.

The students receive instruction in the use and operation of accounting and calculating machines. Companies selling these machines will usually coöperate to make this training effective. A beginner should be familiar with accounting machines and reasonably proficient in operating calculating machines before being assigned to staff work. If adding and calculating machines are not available in the office of the firm, it is worth while to rent them for training purposes.

Beginners are expected to read authoritative works on accounting and related matters. Firms or individuals conducting training courses will probably have their own ideas as to what books students should read, and I will not endeavor here to suggest many books for beginners. However, *The Duties of the Junior Accountant,* by Cipriana, and *The Duties of the Senior Accountant,* by Thornton, are worth consideration when outlining required reading.

Now let us see how beginners are trained where the report-department method is used. Here again men are employed for the audit staff, but with an understanding that they will spend the first weeks or months, or even the first year in the report department before they are assigned to staff work.

Although we are all familiar with the work done by those assigned to the report department, let us see how this work fits in with a training course. One large firm divides the work in the report department into three distinct phases. The beginner is expected to spend a few months on each phase of the work. He is first used as a comparer; that is, he compares rough drafts of reports and statements with the final typewritten report. After becoming experienced in this work he is transferred to the checking section. Here he is responsible for the mathematical accuracy of all figures appearing on statements of the report; for a comparison of amounts mentioned in the text of the report with the corresponding amounts shown on the statements; and for grammatical errors and inconsistencies in text. During the last phase of the work in the report department he verifies by reference to the working papers any "loose" figures appearing in the report. The term "loose figures," as you are undoubtedly aware, refers to those amounts mentioned in the text of the report which do not appear on the statements and which, therefore, can be substantiated only by reference to the audit working papers.

When the beginners are not occupied with their duties in the report department they receive instruction regarding the field work of a public accountant and how they should conduct themselves in clients' offices. They are also encouraged to keep up to date on current accounting literature and to prepare themselves to take the C.P.A. examinations. Obviously, the training a young man receives in the report department impresses upon him the importance of accuracy in dealing with figures and care in the preparation of both working papers and reports. During the period he spends in the report department he also has an opportunity to learn the methods and procedures of his employer, to become acquainted with the type of clientele of the firm, and to obtain a general knowledge of the field of professional accountancy. So much for preliminary training.

In the early part of this paper, I mentioned that staff training should not cease when the beginner is assigned to the audit staff. If a public accounting staff is to be of a high caliber, the progress of each staff member must be followed carefully. Do we not sometimes hear words to this effect? "I cannot for the life of me understand what has happened to Smith during the past six months. The first two years he was with us he made excellent progress but during this past year he has slipped badly. He seems to have lost interest in his work and lately has become careless and inaccurate. I have lost confidence in him." This sort of thing is not unusual, yet a situation like this might not readily come to the attention of a partner of a large firm unless some method is used whereby the progress of each man on the staff is followed. The larger firms, realizing this, follow the progress of staff members by the use of written personnel reports. These reports generally indicate how the accountant in charge grades each assistant; that is, as a senior, light senior, semisenior or junior. They also include information as to the assistant's accounting ability, personality, handling of clients, appearance, etc., and make mention of any outstanding faults.

The type of personnel reports used by the various firms differs widely. Some list the accounting aptitudes and personal qualities on a form and request the accountant in charge to indicate whether "excellent, good, fair, or unsatisfactory" by check marks in columns provided for that purpose. Other firms use a form letter requiring the accountant in charge to write out fully his opinion of each assistant.

Then too, firms differ as to the number of personnel reports they receive regarding each staff member. Some firms require the senior in charge to prepare a personnel report covering the work of his assistants immediately upon completion of each engagement. Other firms request reports from their in-charge accountants quarterly.

It is too little realized, however, that these reports are worthless unless they are systematically utilized as a basis for advancing assistants and for discussion with them of any outstanding faults and how they may be corrected.

In order to obtain a more accurate appraisal of the ability of staff members, they should be assigned to work under the direction of different seniors and on different engagements. Assigning juniors in this way is particularly helpful, because in addition to obtaining an evaluation of his ability by more than one senior it also enables the junior to learn more readily that there is more than one approach to the same type of problem and that records and procedures vary widely with different types of businesses.

There are other ways of assisting staff men in their development, less tangible than those already mentioned, but perhaps no less helpful. For example, we should urge them to sit for the C.P.A. examination as soon as they are eligible; to take an active interest in the activities of accounting societies; continue to read authoritative works on accounting and allied subjects and keep informed on matters affecting professional accountants and happenings in the business world. In this connection a library on accounting and related subjects should be available for the use of staff members when they are unassigned. To keep abreast of matters affecting professional accountants, staff conferences may be held at frequent intervals to discuss changes in tax laws, recent rulings by the Securities and Exchange Commission, and other matters of general interest. Juniors should attend these conferences even though a considerable portion of the matter discussed may not relate to the class of work to which they are currently assigned. If staff conferences are not feasible, bulletins regarding such matters may be used to attain the same result.

Before closing, I would like to point out that the larger firms recognize that staff training is the keystone to a well organized staff. The larger firms have found that on the one hand the beginner has evidence that his employer is investing in his future, while on the other hand the employer has the satisfaction of knowing that staff organization is being built on a sound foundation—that of vertical staff expansion. Training beginners is an investment and one which yields an excellent return, if we continue to follow their progress after they become staff members.

Staff Training Methods

BY VIRGIL S. TILLY, TULSA, OKLA.

Member, American Institute of Accountants

WITHIN our memory, there has never been the need, as now, for ably and thoroughly trained men and women. Today, as never before, there is the urgency of efficiency in industry. This need is pressing in all lines of endeavor because, for the first time since the industrial revolution in this country, goals of production and accomplishment are without limit. Money is no object—only things done are important.

The tempo of the times is affecting the work of our profession and will continue to exert an ever increasing pressure on our ability to get our job done. We are obliged to take stock of our resources in order to match our responsibilities, and doubtless we shall realize then that we must coöperate with each other far beyond the expectations of any of us. Intelligent coöperation is the answer of our way of life to the highly advertised efficiency of centralized control and forced labor with which we are now in competition.

One means by which our resources must be increased is through more attention to staff training. Coöperation is the keynote by which staff training may be improved and thereby increase our resources of trained men and women. Coöperation is particularly necessary with us who are in moderate-sized firms. In meeting our patriotic duty, many of us have been and others will be taken from public practice for service in the armed forces or for urgent work in other agencies of our government. On the other hand, we face a decided decrease in the number of entrants due, not only to the needs of government but also to the greater, immediate rewards offered manual workers. Relatively speaking, the manual worker has gained measurably on the white-collar worker, at least in the first stages of employment. The manual worker is recognized as an important one from the beginning of his employment.

In moderate-sized firms, it is more difficult for us to use the young, inexperienced man. The larger firm has in its work more division of labor. The engagements of the moderate-sized firm basically require men who can easily move from one phase of the work to another. It is, therefore, more difficult for a moderate-sized firm to use a man with no experience. We in moderate-sized firms have, for the most part, drawn on a reservoir of finished bookkeepers and clerical accountants from private employment with or without limited public accounting experience, and have proceeded over a period of years to develop many excellent public accountants. We have done this largely through the apprentice system of training, involving the close personal attention of the principals. Other common means of development of staff men include close review of work and papers, outline of audit programs, use of a firm's manual of audit procedure, and occasional meetings for review of taxation problems and procedure. To this date, staff training has been principally directed to the individual, singly, and related particularly with his current work. Outside reading and study has been encouraged but not compelled ordinarily as a part of the firm's training policy.

Our problems of personnel, present and future, relate particularly to a broad conception of staff training, and in its consideration, we should start from the beginning. That beginning is a matter of public relations and education. We read and are told that a relatively small percentage of the students in accounting and related subjects, enrolled in our colleges and universities, endeavor to enter public practice. Primarily this is due to the seasonal nature of employment offered them and our inability generally to offer employment at the time of their graduation. We are reported to be hard taskmasters, slave-drivers; in fact, a group as a whole which secures men for long hours with small pay. In particularly disappointed minds, we are likened to other employers who are said to have eked their profits principally out of the labor, sweat, and toil of poorly paid employees.

Thus our public relations have suffered. These charges are unfair and mainly reflect extreme occurrences.

Before a medical student has undertaken his studies, he has surely investigated the full extent of the requirements of the medical profession. He is thus fortified in his mind and better able to bear the arduous training period which follows his primary education. Likewise the graduate in law knows that he must acquire experience and maturity in a period of trial and testing, requiring generally a number of years during which his tasks are of a detailed and clerical nature. Schools of law and medicine recognize that they have furnished only the preparatory phase of the student's preparation. As a consequence, the student quite rightly views the following three to five years in the ranks of his profession as a period of further necessary training and education. Pay is of small moment.

Our schools of accountancy should have objectives with reference to their graduates comparable to other professional schools. The proper conception of training for any profession envisages a period of trial, training, and development within the ranks of the profession subsequent to graduation from the schools of learning. Too, this program requires close collaboration between the schools and the profession. This understanding and collaboration between our schools of accountancy and our profession can and should be improved. We must have more respect for each other. If faults exist which preclude the fullest measure of mutual respect, we must each rid ourselves of those faults.

Thus only can a graduate of accountancy approach his first years in our profession with proper understanding. His first ideas come from our schools, and thus far professional education has been secondary to a purely business education. The emphasis has been commercial in sense.

This problem of training embraces, I believe, three broad classifications, namely, character, knowledge, and ability.

One's character training commences early in life. Basically, however, character is in process of continuous development, a process in which the home, church, school, associates, and profession each has a part. Our profession through practitioners, individually and collectively, must continue to foster and demand the highest standards of integrity and ethics, promote habits of industry, order, thoroughness, cleanliness, and teach by precept and example the requisite of those attributes of character with which one can attract the respect and confidence needed for the existence of our profession.

Knowledge is also acquired from early in life, but the type of knowledge with which we are now concerned is particularly that which is acquired after graduation from high school. College education is very desirable, and undoubtedly we must look principally to college-trained men for the perpetuation and continued development of our profession. In addition to technical education, the colleges should provide a broad base of cultural education. Particular emphasis should be placed on education and training in the forms of expression, namely, writing and speaking. Such courses should be required throughout the undergraduate's formal schooling. The responsibility for this type of education rests primarily with the schools. Many accountants today are weak in their ability to express themselves. Many college-trained men and women today are weak in that respect. Our schools could well improve their facilities to obtain more desirable results.

The acquisition of technical knowledge by a professional man or woman is a daily task. From the time a student commences the study of accountancy and related technical subjects to the time he retires from active practice, he must, in order not only to grow but just to keep up, continuously add to his store of knowledge.

The development of character and the acquisition of knowledge are thus highly important responsibilities of both the schools and the profession. The development of ability, however, is largely the task of the profession. Ability is the pay-off. Character and knowledge are truly essential but without ability their fruits cannot be realized in our profession. This thought should be fully realized by the beginner, and he should enter the ranks of the profession with humility in spirit and patience in temperament, in order to reap the full benefits of experience. If he enters with a commercialized sense of values, his professional development will suffer. A man or woman on entering our profession cannot reasonably expect to be paid well before the age of twenty-five, and should never expect to be wealthy. Entrants in some professions hardly expect to realize fair pay before the age of thirty.

In my discussion thus far, I have endeavored to present the problem of staff training in a broad, comprehensive outline, in the belief that improvements basically may be expected only through adoption of long-term policies worked out through close collaboration of schools, practitioners, the American Institute of Accountants, and state societies of certified public accountants. In summary, I have hoped to present the following line of thought:

1. The need for an increase in our resources of trained personnel.
2. That closer coöperation within our profession is a prime necessity.
3. Recital of past practices, worthy of continuance, of moderate-sized firms, in attracting and developing personnel.
4. That a broad conception of improvement in staff training demands first an improvement in our public relations and primary education.
5. That the problem of training embraces three broad classifications, namely, character, knowledge, and ability, and that our profession has a substantial responsibility, in the training of personnel in each classification.
6. That beginners in the ranks of the profession should reasonably expect a trial and testing period of three to five years.

Into this broad outline, it is my assignment to fit a program for moderate-sized firms.

First, I suggest that these firms assume their proper share of the responsibility in promoting closer collaboration with schools and better understanding with the students. More substantial support of the schools by the profession is needed if schools of accountancy are to serve primarily as professional training schools. We must eliminate the stigma of seasonal and temporary employment. I know from experience that our work can be so arranged that so-called temporary work can be almost wholly eliminated. Interim audits and the application of the natural business year can enable a moderate-sized firm to distribute the work more uniformly over the entire year, and thereby maintain a uniform staff throughout the year. There will be some overtime, yes, but offset by some idle time and vacations with pay.

We must take our share of the new crop of graduates for training. In the past, we have failed to take our share, leaving the burden chiefly with the larger firms.

Coöperating with our professional societies, there should be collaboration with the professors in the outline of the courses, lectures by practitioners, and an arrangement by which the offices of practicing accountants may be used for field work from January 1st to April 1st of each year. This latter arrangement is suggested not only as an emergency substitute next year, but as part of a long-term training program. This arrangement could be particularly successful in offices of moderate-sized firms, for generally a beginner can have a more broad experience there than in the offices of the larger firms.

I believe that the general adoption of those policies would have the effect of providing a greater reservoir of men for entrance into the profession and further simplify and make more effective the training methods employed within the profession.

Training within the profession may be classified as follows:

(a) Through sponsorship of professional societies;
(b) Within the practitioners' offices.

Much headway has been made in the past year or so by our professional societies in the sponsorship of technical discussions. State societies have inaugurated midyear meetings devoted entirely to technical discussions. Conferences of societies of various states have been so organized and the results have been helpful. The Texas Society has inaugurated a program of accounting institutes in which the Society and the several schools have collaborated with outstanding success. The American Institute of Accountants and the state societies should continue and perhaps extend the scope of such meetings. In addition, they should establish and strengthen local chapters of certified public accountants which will have the active support of leading practitioners, both in administration and in technical discussions.

Training within practitioners' offices could be extended through coöperation between firms. Responsibility for promotion of this type of coöperation properly rests with the state societies. It would be refreshing for us to rid ourselves of personal inhibitions that may otherwise hinder this type of coöperation. We may well appreciate this type of coöperation, which simply is an extension of our present degree of cooperation as exemplified in our state societies and in the American Institute.

With the expectation of a shortage in personnel within the following months, the suggestion has been made that we coöperate in the employment of staff. That may be practicable in isolated instances, but generally it appears impracticable, in my opinion. Rather, I suggest that we better organize our work and carry a full staff throughout the year. With some feeling of permanence and a future, we shall have a more loyal personnel and more potential entrants from our schools.

Accountants and the Wage and Hour Law

BY SPENCER GORDON, WASHINGTON, D. C.

Of Counsel for American Institute of Accountants

GENTLEMEN, you all probably remember, or some of you, before we had the movies, we used to have vaudeville shows, and there would be a number of acts. The show would usually start about two-fifteen, and then about half-past four, they would get to the last act, and that usually would be something pretty poor, something that would gradually get the people out of the theater in an orderly way. That is all right with me. You can follow the old custom and just go ahead when you are ready, but I just want to tell you one thing—if you stay, I am not going to pay you overtime.

The only thing that bothers me about it, really, is that they never let me pick my subject. I have some real good addresses that I have always wanted to deliver. I have one on "Bigger and Better Fees for Accountants," and one on "The Life of the Accountant after Dark." I have never had a chance to show what I can do. Whenever they get around to me, it is something like "The Liability of the Accountant," or "Wages and Hours," or something of that sort.

Here I am again, wages and hours. I will do the best I can with it, and I guess I had better begin.

Well, the first thing that lawyers always want to know and people want to know is whether an act is constitutional. Some always contend that it isn't constitutional. You needn't worry about that any more. The Supreme Court has had two cases, the Opp case [1] and the Darby case,[2] and they have held the act constitutional; so that is the end of that, and there is no use telling you why, but it is. That much has been accomplished anyway.

The next thing that we want to know is rapidly becoming equally simple. At first there was quite a question whether the employees of independent certified public accountants were engaged in interstate commerce or in the production of goods for interstate commerce. If they were not, they did not come under the act, and that was all there was to it. In my innocence, when the act was first passed I divided the accountants up somewhat as follows: Some of the large firms might have offices in a great many states, and they would constantly be writing letters back and forth and people might travel around, and I thought that maybe somebody might think there was some interstate commerce there, or that they might not. Then I thought there would be other accountants who perhaps had offices only in one state, but had clients in other states and would send their men out, and there might be some traveling around and letters written, and so forth. I thought there might be some question about that, but I was consoled by the decision of Judge Holmes in the old baseball case.[3] He held that personal effort not related to production was not commerce. To illustrate, he said that if a lawyer went from one state into another state to argue a case he was not engaged in interstate commerce, because he was engaged in a professional activity which was not commerce at all. I thought, as Judge Holmes was the Patron Saint of the original lawyers in the New Deal, they might possibly follow his decision.

Then there were the accountants whose activities were confined to one state. California is a big state, and there are some pretty high mountains, and an accountant in San Francisco might not have any clients outside of California. I thought in my own innocence, as I say, that probably nobody would contend that he was engaged in interstate commerce.

But it is all different from that. The Administration contends that the accountants who have offices all around are engaged in interstate commerce, and that the men who go to other states are engaged in interstate commerce. The Administration also contends that if accountants' employees work on the audit of accounts for clients who are engaged in interstate commerce, then the accountants' employees are themselves engaged in the production of goods for interstate commerce. Even in the case of the accountant in San Francisco who has no clients outside of the state and whose men are working on the affairs of retail stores in San Francisco, the Wage and Hour Division contends that his men "would seem" to be engaged in the production of goods for commerce, because the reports which they give to the retail stores may in turn be given to credit agencies in other states, and if the accountants have reason to think that will be done, then they are en-

[1] *Opp Cotton Mills* v. *Administrator*, 312 U.S. 126 (1941).

[2] *United States* v. *F. W. Darby Lumber Co.*, 312 U.S. 100 (1941).

[3] *Federal Baseball Club* v. *National League*, 259 U.S. 200 (1922).

gaged in the production of goods for interstate commerce.[4]

When they begin talking that kind of law, I just have to give up. It doesn't sound like anything I ever heard before, but there it is. As to whether your employees are engaged in interstate commerce and are thus within the act, I think as a practical matter you can pretty nearly assume that all of them are going to be so considered by the Administration for one reason or another, and I am inclined to think that with the very broad conception of interstate commerce, which is sincerely held by the partisans of the New Deal, the courts are very apt to sustain the Administration in that view.

So I think as a practical matter you can pretty well consider that it will be an unusual employee of an independent certified public accountant who will not be held to be engaged in interstate commerce, or the production of goods for interstate commerce under the theory held by the Administration.

Of course, I am familiar with the fact that some district courts have made decisions[5] which lend hope to the original views which I held as a young man three years ago, but those cases haven't gone to the Supreme Court yet, and I really do think that you haven't much chance of getting out of the interstate commerce end of the problem. If I am wrong about that, of course I shall be perfectly delighted to come back and tell you so when it happens.

That disposes of constitutionality and interstate commerce. Now, let us talk about the professional exemption.

In regard to the professional exemption, the act says in effect that people who are engaged in professions as defined and delimited—whatever that means; I know what "defined" means, but if any of you know what "delimited" means, that is something different—by the Administrator. People who are engaged in professional work do not come under the act. Of course the question came up: Are accountants who are employed by other accountants professional men and thus exempted under this exemption provision? Of course accountants are professional men. We all know that. Not only do we know it, but the Administrator has recognized the fact. In his study of this subject, there is a page or so about the practice of accountancy, and he speaks of it as one of the not-so-ancient professions as law and medicine, but a modern and very active, a very important profession. So the fact that accountants are professional men is clearly recognized.

The original regulations which were issued by the Administrator defining professional men had a definition which I shall not repeat at length. You are all familiar with it. But in general it was a man who had a certain amount of education and who used his head rather than his hands, and so forth, and the accountants came very well within that definition, that is, men who were real accountants.

That definition remained in effect for two years, and then about this time last year, the definition was changed in some minor details which would not have affected the accountants, but in addition there was included the provision that in order to be a professional man you had to receive $200 a month.

So the situation in regard to the professional exemption is this: That if a man is a professional man, then for the first two years of the act he is exempt. If he is a professional man, he is now exempt if he gets $200 a month. Well, I must say there are disadvantages, but there are also certain practical advantages to this $200 a month business. The fact that we have this $200 a month provision, coupled with the fact that accountancy is recognized as a

[4] See Administrator's Release of April 15, 1941.

[5] *Gerdert* v. *Certified Poultry & Egg Co.*, 38 F. Supp. 964 (1941); *Farr* v. *Smith Detective Agency*, 38 F. Supp. 105 (1941); *Abadie* v. *Cudahy Company*, 37 F. Supp. 164 (1941).

profession, creates a situation where at the present time if an accountant is employed and he gets $200 a month, there is no doubt at all of his being exempt. It gives the enforcing officers a very simple way to decide the question. No. 1, Is he an accountant? No. 2, Does he get $200 a month? If so, he is out of it. If he gets less, we are sorry, but he is in it.

Now, don't forget this: That definition which was made about a year ago is not retroactive. You must all remember that, because I find that some people do not seem to get that straight. During the first two years, if you have any man who is really a professional man, who comes under the definition fairly, even though he gets less than $200 a month, he would, nevertheless, be exempt. For instance, I should think that during the first two years you would not have any trouble in securing an exemption for a certified public accountant, even though he did not get $200 a month, because he is clearly a professional man; he has been given the badge of office, so to speak, by getting his certificate. If a man was not a certified public accountant, then you would have to show what kind of work he did, and show that he really did come within the professional definition.

Of course, when this $200 a month provision was put in, we didn't like it, and the Institute filed objections to it. Mr. Wellington appeared on behalf of the Institute and we have had conferences in Washington. He saw the Administrator personally. He tried to get them to take off the $200 provision, but the Administrator would not do it. I have been somewhat interested to note that one of the arguments he made has been sustained by one court, at least, and I still think this $200 provision is just about as illegal as anything could be. Section 13 (a) of the act[6] provides: "The provisions of sections 6 and 7 shall not apply with respect to any employee employed in a bona fide . . . professional capacity . . . (as such terms are defined and delimited by regulations of the Administrator)." That is what the act says. The Institute said to the Administrator: "Whether or not a person is employed in a professional capacity depends on the nature of his services, and not upon his salary, and the words 'defined' and 'delimited' do not, we believe, authorize or permit the Administrator to require compensation at any fixed amount for inclusion in the professional class. If the word 'delimited' may permit in any case a requirement of compensation at a fixed amount, the figure of $200 is arbitrary as regards accountants who are employed by independent public accountants, since the $200 requirement excludes approximately one half of these accountant employees and thus largely destroys the effect of the professional exemption granted by the statute."

In other words, if the statute exempts professional men and you have a class of professional men, of which practically 50 per cent of the employed members get less than $200 a month, and then the Administrator puts in a $200 requirement that eliminates half of the professional class, there is something wrong about it somewhere.

I was interested to note that as recently as about a month and a half ago in a case in the District Court in Georgia[7] there came before the court the provisions relating to executives. You all will recall that as to executives the Administrator has made a salary requirement of $30 a week. The court held that this limitation was illegal, that it was up to the Administrator to define what an executive was, but that he could not put in as part of his definition a perfectly arbitrary requirement that the man get $30 a week. He was an executive or he was not, according

[6] The fair-labor-standards act of 1938.

[7] *Devoe* v. *Atlanta Paper Company*, U.S.D.C. No. Dist. Ga., July 31, 1941.

to what he did, not according to what he was paid, and the court pointed out that in Washington there were sometimes men who received a dollar a year, but they were, nevertheless, executives, and mighty good ones.

That rather interested me, because as far as that court went, at least, it sustained the idea that we had, that the business of saying that an accountant was a professional man or was not a professional man, depending on whether or not he got $200 a month, is all wrong and illegal. I know, although fortunately I get $200 a month, it was many years before I got $200 a month practicing law, and it would have hurt my feelings very much to have had people say I was not a professional man, and in some respects I was more one then than I am now.

After being on this program today after six accountants I can go home and say that I follow the accounting profession. I am reminded of a witness in a case in Washington. They put him on the stand and asked him what his profession was. He said, "I follow the medical profession." He was an undertaker.

Another phase of this act that we are all interested in is how are you going to determine what the wages are and when you pay overtime. That gets you into the problems of higher mathematics which are a little bit hard to debate here with such a large audience and without a blackboard and a book on algebra.

In the first place, here is a pretty little play that was written by somebody, called "Interpretative Bulletin No. 4." You have probably all seen that. It has been revised several times, and it seems to be more or less the bible. It tells you what you can do and what you can't do. It seems to me in looking at the thing, as the amateur that I am in accounting matters, the problem seems to have been that the accountants want to comply with the act, of course, and they want to pay their men a reasonable amount, and naturally, because of income-tax returns and other seasonal requirements, accountants have to work very much harder some times in the year than in others, so the problem is how are you going to pay the man the time and overtime, and also some sort of a salary that will keep him running along through the year, so he will not have too much at one time and too little at another. There have been various ways of doing that. Some accountants use the system of employing a man at so much an hour and so much for overtime. They do not guarantee him anything, but they say they will advance him enough so that he will get in his pocket at least a certain amount per week, and then he owes them a certain amount, and then when he works overtime, he catches up.

The Bureau seems to think that is all right, but of course in order to do that, you have to start out in a slack period so the man will get to owing you. The trouble is you do not usually employ them in those periods; you are more apt to employ them in a busy period, and then if you do it that way, you get to owing the employee, and that is all wrong; you cannot do that. Nevertheless, I call that method to your attention as one way of doing it, if possibly it suits your system of operation. However, the Bureau has been very emphatic from the start in saying that if you employ a man at so much an hour, but give him a guaranteed salary of so much, then his salary is a guaranteed salary, and they will recompute it and make you pay overtime beyond that. I won't go into the gruesome details, but you all get the thought.

I am happy to say that a very well thought of court has spoken on that point in no uncertain language. This was in the case of *Administrator* v. *Belo*, a decision of the United States Circuit Court of Appeals for the Fifth Circuit.[8] The opinion is by Judge

[8] *Administrator* v. *A. H. Belo Corporation*, CCA 5th, June 27, 1941.

Hutcheson, and one point of importance in the decision lies in the fact that Judge Hutcheson is recognized by the Administration as a very fine judge. He was prominently mentioned as a possible appointee of President Roosevelt to the Supreme Court. He has always been known as a liberal judge.

In that case the newspaper had a contract which seems very similar to the kind of contract that I have heard the accountants say they want to have. The employees there were the editorial writers and the reporters of a newspaper. Those men, of course, work very irregular hours, and they would work a long time sometimes, and sometimes they wouldn't, and the newspaper agreed to give them 75 cents an hour for 40 hours a week, with time and a half for overtime, but with a minimum guarantee. Here is what the contracts said:

"In order to conform our employment arrangements to the scheme of the act your basic rate of pay will be 75 cents per hour [9] for the maximum number of hours each week as specified by the act, and that for time over the maximum number of hours specified you will receive for each hour of work not less than one and a half times such basic rate above mentioned, with a guaranty on our part that you shall receive weekly for regular time and such overtime as the necessities of the business may demand, a sum not less than $45."

In other words, the newspaper and the reporters and editors contracted that the employees would receive 75 cents an hour for a 40-hour week with time and a half for overtime, but that they would be guaranteed $45 a week. As I understand it, that is exactly what you would like to do. Now, the Circuit Court of Appeals held in this case it was all right, that the employer had a right to do that, there was no violation of the act, and that the Bureau's objection to it was without weight.

The Administrator is applying for certiorari to the United States Supreme Court, and if the certiorari is granted then this particular question will probably be decided by the highest court, and you will know where you stand on that. Either you will have to do the way the Wage and Hour Administration says, or else you can go ahead and do it the way you would like to do it, the way the newspaper did in this particular case. But, for the present I should say the only safe thing to do is to follow the regulations as set forth in Administrative Bulletin No. 4.

I am not going to tell you the contents of these pamphlets, you probably know them yourselves, but just in order to give you an idea of the literature on the subject, there is also this Interpretative Bulletin No. 13, which has to do with hours worked. It covers all such subjects as time off for lunch, waiting time, travel time, etc. It will answer a number of questions on those subjects. Of course, you all ought to know there is such a bulletin. There is No. 4 and there is No. 13.

There is a release that has just come out September 2, 1941, on the question of the position of the Administrator on bonuses. With some hesitation I shall try to tell you what that position is. It seems to be that if the bonus is given by the employer at the end of the year without any obligation to give it, but he has a profit and he decides to give some of it to his employees to encourage them, but if they have no right to demand it, then apparently it is a bonus and you do not have to recompute the wages and hours. But if the bonus is given as a result of any profit-sharing scheme which has been announced in advance, and which therefore constitutes a contractual obligation on the part of the employer, then you have to recompute the wages and hours and consider this bonus as addi-

[9] In every case the amount is above the minimum.

tional pay spread over the whole year, and if the employee has worked overtime, then you have to give him a little more for the overtime.

I had thought, in spite of the rather dubious subject that they gave me, that the ice would be broken by my good friend Mr. Hall, and that he would tell you all about it, and that all I would have to do would be to say I agreed with whatever he said. But when I got out here, I found that Mr. Hall had disappeared, and his contribution was a series of eleven questions which he left for me to answer. There is nothing like giving you a good show, so here we go. I shall read the questions, and then I shall answer them.

1. Referring to Wage and Hour Division release of April 15, 1941, in which the Division holds that the fair-labor-standards act is applicable to accounting firms which prepare reports or statements that are sent outside the state, would an employer be justified in assuming that his liability, if any, would commence with the date of the release, that is, April 15, 1941?

That question brings up an important point. The answer is "No." The liability depends on the act itself. It does not depend on the interpretation that the Administration may put on it, and if the Administration does put an interpretation on it, we have to assume that that interpretation relates back to the beginning of the act. The professional definition is an exception. You will recall I told you that the professional definition that was made about a year ago began at the time it was made.

The reason for that difference is that the statute refers to "professional men" as defined and delimited by regulations of the Administrator, so the Administrator must define the class. His definition thus determines what they are, until he defines them in some other way. If he later defines them another way, then that is what they are.

But that isn't so about anything else in the act. I think the easiest way to think of it is this: It may take the Administrator and all the rest of us some time to find out what the act has meant, but when we do find out, it has meant that all the time (except as to the professional definition).

2. Referring to the third paragraph of Wage and Hour Division release of April 15, 1941, in which the Division holds that the fair-labor-standards act is applicable to accounting firms which prepare reports or statements that are sent outside the state, would you say that the cautious statement that employees of such accountants "would seem to fall within the general coverage of the act" indicates doubt on the part of the Administrator as to whether he will be able to make his ruling stick in the courts?

I think it indicates doubt on the part of the Administrator that his ruling is correct. That is the thing I talked about earlier, a very broad extension of the conception of interstate commerce, and when the Administrator extends it to practically the breaking point, then he begins to use such words as "would seem" instead of stronger words.

3. Are nonprofessional office employees of a firm of accountants whose business is largely intrastate covered by the fair-labor-standards act?

That question is not definite enough. It depends on what he does.

4. Does the Wage and Hour Division still contend, as indicated in Interpretative Bulletin 13, that staff members must be paid overtime for time spent after business hours attending meetings and lectures organized by the employer for staff training purposes?

I should say generally it probably would consider that that was time spent on work. The test, according to the Administrator, would be something like this: Of course if the man was required to attend, then that would be part of his work. If the lectures had to do with his particular duties with that particular firm, something of that sort, it would be. You can conceive, however, of lectures that might have to do with accounting matters generally, such as in an accounting school, and those might not be. It would depend on the particular case, but the probabilities are that it would be considered work.

5. What is your view as to the legality of the salary test in the revised definition of professional employees?

I have already given that. I think the salary test is illegal, and there is an excellent chance that some day the courts will knock it out, as one district court has already done in regard to the executive.

6. What is the present position with regard to HR-5268 introduced July 19, 1941, which would amend the fair-labor-standards act so as to permit employers and employees to contract for a guaranteed weekly sum without increasing the regular rate of pay otherwise fixed by the contract?

I do not think there is any chance at the present time of legislation going through to amend the act. There was some legislation a year or so ago which everybody thought was going through. It finally failed, and there is not any project on foot at the present time to amend the act which seems to have the necessary backing.

7. Would you advise accounting firms to make contracts with their employees at a basic rate of 30 cents per hour for the first 40 hours with time and a half for overtime and a guaranteed minimum approximating their present salary?

I do not think I would advise doing it at this moment, but I would watch the Belo case and see how it comes out in the Supreme Court.

8. Does the Wage and Hour Division consider the fluctuating week a proper basis for calculating overtime compensation in an accountant's office?

I think they do. If an accountant has a fluctuating week, and I imagine they all do, if they want to work it on that basis, apparently it can be done under Bulletin No. 4. Certainly there is nothing about an accounting office that would make it any different from anyone else who might have a fluctuating week.

9. What are the prospects of the regulations to the Wage and Hour Division being amended so as to permit accounting firms in particular to grant time off with pay in the slack season in settlement of overtime work during the winter months?

There is no chance of their doing that, in my opinion.

10. Have you any idea when the revised record-keeping regulations discussed at the hearings held in Washington on October 17 and 18, 1940, and on May 12, 1941, will be released in final form?

They were released the day before yesterday.[10] Instructions will also be issued sometime later.

11. Are back-pay settlements deductible by an employer in the year in which settlement is made, or the year or years in which employees' services were rendered?

I shall refer that to the committee on federal taxation, and if they refer it back to me, I should say to deduct them in the first year you can, and if that is knocked out, then deduct them in each successive year until you make it stick.

---

[10] September 15, 1941.

VI

Addresses

Impacts of the War on the Profession in Canada

BY GEORGE C. MCDONALD, MONTREAL, CANADA
Member, Dominion Association of Chartered Accountants

I WOULD LIKE to begin with a brief statement concerning Canada's war effort as a background for my paper. I promise to arrive promptly at my subject and to keep within my time limit.

In the last war, out of a population in 1914 of 7,879,000, Canada raised 500,000 men voluntarily and 125,000 by conscription for war service, or one in thirteen of the population. In 1918, it was supporting in France the Canadian Corps, a very strong unit. At the same time, it was supplying munitions and supplies for war of $50,000,000 a month. At the beginning of the war, the net debt of Canada was $336,000,000. At March 31, 1919, it was $1,575,000,000. In the interval, special war taxes were levied and have been in effect ever since. Incidentally, from their inception to March 31, 1939, these taxes have produced over $800,000,000 in excess of the cost of the war, demobilization, soldier, and general land settlement, soldiers' civil re-establishment and pensions. Thus by the time the new war started, the total cost of the old war had been paid off by the war taxes collected and a substantial surplus turned in to the consolidated fund.

Towards the end of 1917, it was considered necessary by the government to enforce conscription for military service. The men in France were glad to have the reinforcements, but when they got back to Canada, they were rather shocked to find that there had been no other form of conscription of man power in either industry or finance, and that many war fortunes had been made. To an extent this has been remedied in this war.

At the start of this war, Canada, like the other democracies, was not in a position to put a trained and equipped army in the field. The first steps taken were immediately to call for volunteers to provide two divisions for active service, and arrangements were made to mobolize the production of war supplies and equipment. To the veterans of the last war, it seemed poetic justice that the first steps taken by the government practically amounted to conscription of finance and industry. (I refer to the income and excess-profits taxation, the national-defence tax, the Foreign Exchange Control Board, and the Wartime Prices and Trade Board.) It was decided, in so far as service outside of Canada was concerned, to rely on the voluntary system for recruits. Based on the military plans previously arranged between Britain and France, it did not seem necessary immediately for Canada to send proportionately as many men to Europe as in the last war. At the same time it was realized that the increased mechanization of war called for more men in factories in proportion to those in the field. In addition to help from the Canadian Army, Navy, and Air Forces, what Britain was looking for from Canada was:

1. A supply of munitions and equipment for war purposes on the scale

of supply at the end of the last war, viz., 50 millions monthly and double that in the second year.
2. Recruits for the Air Force and Navy.
3. Technical assistance.

We were trying to cling to the voluntary system, regarding both our willingness to fight and our ability to work and produce, because we have been living in a capitalistic economy and the profit motive is still the driving force behind present-day economic activity. However, the events in Europe in April and May, 1940, gave the world a shock, and in Canada it produced the national-resources-mobilization act and similar acts in Australia and New Zealand. The Canadian act, the wording of which was practically a copy of Mr. Churchill's emergency powers (defense) act, 1940, gives the government complete power to conscript man power and property for industry and the defence of Canada. The extent of the government's power in this respect is not properly understood either inside or outside Canada. Perhaps the reason is that the government has not yet been very aggressive in asserting its powers. It has called up certain age groups for military training and is retaining them for the defence of Canada for the duration of the war, and it has greatly increased already high taxation.

Under the voluntary system, Canada already has over 320,000 men in service in the Army, Navy, and Air Force, of which about 100,000 are already in England. In addition to this, there are in the Reserve Army (formerly the Canadian Active Militia) 170,000 men. This makes a grand total of 490,000 men available for service, or one out of 23 of the population of Canada.

Canada's war spending has increased steadily and momentously. In the first five and a half months of the conflict, the Dominion spent approximately $118,000,000 on her own preliminary war activities. In the 1940–1941 fiscal year (April 1, 1940, to March 31, 1941), direct expenditure for war was $792,000,000. The amount spent in the first three months of 1941 was about five times as great as the amount spent in the first three months of 1940. The current rate of war spending on Canadian account is well over $1,000,000,000 a year. It is expected that Canada's contribution in direct war expenditure for her own account in the current fiscal year (April 1, 1941, to March 31, 1942) will be approximately $1,450,000,000, or over $125 per head of population—nearly twice as much as the amount spent in the past fiscal year. This is a direct outright and unreserved payment by Canada to the cause of freedom.

In addition to this direct expenditure on her own war requirements, Canada provides Great Britain with Canadian dollars to finance the bulk of British war purchases from Canadian firms. By repatriating Canadian bonds held in Britain, Canada is today paying obligations which ordinarily would not fall due until future years. By accumulating Sterling balances Canada, in effect, lends Great Britain money. Canada has to date supplied Britain with about $750,000,000 in these ways —about three quarters of Britain's trade deficit with Canada since the beginning of the war. The net amount which Canada expects to provide for this purpose in the present fiscal year, which ends on March 31, 1942, amounts to between $800,000,000 and $900,000,000.

I should like to make it clear that whatever gold or United States dollars we get from Britain to help pay for the goods they get from us, Canada uses immediately to pay the United States for war purchases. Any gold coming from Britain does not reduce by one dollar the amount which must be raised from the Canadian public in taxes and loans.

From Canada's point of view, these facts cannot now be too strongly emphasized or too often repeated, because there has been some vicious propaganda which persists in many quarters to the effect that Canada is demanding cash on the barrel head for everything she supplies to the United Kingdom. Nothing could be more cruel or unfair than such statements.

All this expenditure means heavy taxation to the Canadian. It has been levied by the government and cheerfully accepted by the people. Profiteering is impossible because of our heavy excess-profits tax, our income tax, and the defence tax of 5 per cent to 7 per cent, which applies upon the gross income of all citizens whose annual income exceeds $660.

Canada's effort to finance the war without inflation is reflected by the following:

1. Public borrowing and subscriptions to war savings certificates to date aggregate $1,300,000,000.
2. Complete control of industry and finance by various measures:
   - Income-tax act
   - Excess-profits-tax act
   - National-defence tax
   - Wartime Prices and Trade Board
   - Foreign Exchange Control Board
   - Wartime wages policy under order-in-council P.C. 7440

I quote as follows from a supplement to the *Labour Gazette* of July, 1941, dealing with Canada's wartime wages policy:

"Taxes on corporation profits range from a minimum of 40 per cent on total profits to a maximum of between 80 per cent and 89 per cent of excess profits. In 1939 such taxes amounted to about $78,000,000. This year they are expected to yield $385,000,000,—considerably more than total dividends paid in any recent year. Then when these profits (that is any profits remaining) are paid out as dividends, they are subject to further heavy taxation under the personal income tax. Security prices are supposed to reflect present and prospective profits. Toward the end of June, 1941, common stock prices were nearly 33 per cent lower than during the first month of the war."

"All are agreed that none shall profit from the war. This policy is expressed in the government's efforts to control and tax profits, to control prices and rents. It must be rounded out by control of wages, for they constitute two thirds of the national income."

That is the background facing the profession in Canada today.

In Great Britain before hostilities commenced, the government announced that qualified accountants over thirty years of age would be reserved, although they may volunteer in the armed forces. Accountants are also registered as to professional history in a central registry of the Ministry of Labour. Selections are made from this registry whenever the government requires qualified men, either for particular work or to serve in the accounting branches of His Majesty's forces. There is no compulsion to accept such service, but many members have done so.

To illustrate the present situation in England, I quote the following extracts from recent addresses by the presidents of two of the leading accounting societies:

Institute of Chartered Accountants of England and Wales, May 7, 1941:

"On the question of national service, there is one point I would stress, namely, is the best use being made of the services of qualified accountants? I cannot think the answer can be in the affirmative. While I appreciate the many difficulties of always putting the right man in the right place, it is surely a waste of man power for qualified men to be serving in the lower ranks of the Pay Corps or the Accountancy Branch of the Royal Air Force. In the very nature of things, they cannot have to deal with financial problems such as abound in the professional life, nor are they faced from day to day with the manifold problems which arise from taxation and war-time legislation. Conversations are now taking place with the responsible government departments which will, I hope, result in the removal of some of these anomalies."

Annual Meeting of the Society of Incorporated Accountants and Auditors, May 22, 1941:

In his address to members, the president referred to the fact that, although accountancy was recognized as of national importance and was scheduled as a reserved occupation, large numbers of the members of the Society were serving with the armed forces of the Crown and many others were serving in administrative and executive positions in military and civil service. As a result, accountancy firms had been seriously depleted and it was becoming increasingly difficult to meet the normal demands of the profession.

"But the difficulties under which the profession is functioning," said the president, "have been accentuated by the ever increasing volume of work and burden of responsibility arising from war legislation and emergency orders—purchase tax, limitations of supplies, commodity and raw material controls and pools, concentration of production, war damage—these are only a few of the measures in which auditors' accounts and certificates are called for.

"The attempt to meet all these obligations has involved a growing strain on our members, and while we do not complain and gladly regard it as our contribution to the Nation's war effort, we felt we were justified in looking for a measure of support by the authorities so that we could hope to retain the remaining qualified and experienced members of our staffs."

In order to get a proper appreciation of the growth of the profession in Canada, I would emphasize that at the end of the last great war in 1918, the membership of the Dominion Association of Chartered Accountants was only 548. I would say that the profession had received a tremendous impetus from that war. This was due to the business boom in Canada arising from war production, along with the coming of the income and excess-profits taxes. In the interval since the last war, the profession has continued to develop proportionately to the growth of the production and the population of Canada, as well as the increasing complexity of business and the ever multiplying taxation and statistical problems. The population of Canada in 1939 had risen to 11,315,000. While in the interval the profession has been a training ground primarily for itself, it has been turning out an ever growing number of members who become controllers and executives for industry and finance, and many government officials, particularly in taxation and finance departments.

In 1941, the membership has reached 2,314. The average increase during the last fifteen years has been about 100 per annum. It is interesting to note that the trend of the increase has been greater towards chartered accountants employed outside the profession. In 1935 the percentage of members of the Dominion Association of Chartered Accountants engaged in practice was 69, and those employed outside, 31. In 1939, the percentage of those practicing was 62.4, while those employed outside was 37.6. In 1941 the figures were—practising 54.2 per cent, employed outside 38.7 per cent, C.A.S.F. 7.1 per cent.

The 7.1 per cent represents the 179 members who have been enrolled in the C.A.S.F.—Army, Navy, and Air Services. Quite a few of these had been through the last war and had maintained their connection with the Militia in the meantime. As the formation of the Active Service Forces was in large measure based on the Canadian Active Militia, those who had maintained their connection were naturally the first to get into the new war. I think that Canada owes a special debt of gratitude to those citizens who stuck to the militia through many long years of pacifist criticism and discouragement and who were ready when the call came again.

In Canada at the outbreak of war, it was expected that accountancy would be a reserved occupation as in England, but no formal steps were taken. I understand that recruiting officers were told not to accept qualified men for enlistment in the ranks. Amongst the profession the impression got abroad that chartered accountants were going to be called upon to play quite an important part in their own profession, as already in England they were being withheld from enlisting in order that they could be used to check up the cost of war orders.

Actually, the first impact of the war on the profession in Canada was expressed in a questionnaire which was issued by the Dominion Association of Chartered Accountants to its members in May, 1939, for the purpose of compiling a national registry of the names and particulars of the members of the profession who would in time of war or other national emergency be prepared to offer themselves for appropriate work in their professional capacity, and if not already engaged in more important duties from the point of view of national defence, to accept such suitable work as might be offered. This questionnaire was filled in by a large majority of the active members and over one thousand filed with the government at Ottawa. This registration was used for the Foreign Exchange Control Board and the Air Force Pay Corps, and I understand that about a hundred chartered accountants responded to requests to join these organizations. There have, however, been large inroads made on the individual personnel of the profession for special jobs.

Among the senior positions which members of the profession have been called upon to fill in special government service and war organizations were the following:

Members of—
- Board of Referees—Excess Profits Tax Act
- Labour Coördination Committee
- War Contracts Depreciation Board
- Wartime Requirements Board
- Executive Committee, Department of Munitions and Supply

Supervisor, Foreign Exchange Control Board
Comptroller, Munitions and Supply Department
Secretary, War Contracts Depreciation Board
Director, Wartime Merchant Shipping Limited
Administrator, Wartime Prices and Trade Board
Executive Assistant to Minister of National Defence
Special Assistant to Deputy Minister of National Defence for Air
Assistant to Deputy Minister of Finance
Head of Statistical and Records Branch

I would also emphasize the fact that the majority of these members are as a rule quite senior members of the profession and therefore a much greater loss to their firms. While some of these are doing work of a strictly professional character, many are holding very important executive and advisory positions and dealing with matters outside the regular scope of the profession.

While the war has in many instances doubled and trebled the activities of private enterprise, government activities have multiplied even more, and there has resulted a drain on the accounting profession from all sides—

1. Its own activities have increased.
2. The Active Service Forces have taken many members and assistants voluntarily and in certain age groups by conscription for home service.
3. The industry of the country is asking for more qualified men.
4. The government wants more men for—
   (a) The Department of National Revenue.
   (b) The Foreign Exchange Control Board.
   (c) The Department of Munitions and Supply.

(d) The Treasury Board.
(e) The Auditor General's Department.

5. The British Purchasing Commission has taken some members and clerks.

While the loss of qualified men has been serious, the loss of juniors and intermediates has naturally been greater, and in many instances, it has been disconcerting. It has been possible to make some replacements with older men, and in quite a few instances, women are being given an opportunity in the profession.

The following have all made more complications for business and therefore for accountants:

New taxation—Excess profits, national defence tax, federal succession duty
Unemployment insurance
Foreign exchange control
Custodian of enemy property
War savings certificates and war loan deductions
Government contracts

Some of the legislation is very complicated and requires far more time and attention for all concerned—the taxpayer, his auditor, and the tax collector. For example, the excess-profits tax and the calculation of average profits in standard period, the capital employed, depreciation allowance, both ordinary and special, and inventory reserves. The business boom and the war activities have doubled and trebled the amount of accounting to be done by both our clients and the profession.

A major feature of our wartime practice has to do with presenting cases for our clients before two new judicial bodies which have been formed,—the War Contracts Depreciation Board and the Board of Referees under the excess-profits-tax act. As the problems that come before these bodies are so essentially accounting, our profession is very welcome in these courts.

Accountants are more and more being called upon to specialize as tax experts and, as you all know, that particular branch of our profession is a very great time consumer.

In addition to the qualified men on active service, there are probably between two and three times as many registered students in the different services. At the end of the last war, students who had been overseas were allowed one year off apprenticeship. I should think it very probable that similar consideration will be given to those serving in the present war.

I quote the following reference to the employment of firms by the government, from the editorial columns of *The Canadian Chartered Accountant:*

"*Use of Firms' Own Auditors:*

"We were interested in reading a reference last month in *The Accountant* (London) to a discussion on this very matter in the British House of Commons. . . . The Minister of Supply was asked whether he was aware that inconvenience and dislocation of work had been caused by the visits of accountants from more than one department of the government to the same firm and whether steps would be taken to avoid this overlapping in future. The Minister replied that he was fully aware of the danger of overlapping by the accountants of purchasing departments who were concerned with the costs of the same firms. On becoming aware of the situation he had caused steps to be taken to eliminate duplication of visits by accountants in future and had arranged that the department principally concerned with a firm's costs would investigate them for other departments of the government. Of possibly greatest importance was his next statement: 'I may add that it is hoped to diminish the necessity for visits by departmental accountants to investigate firms' costs by utilizing the services of the firms' own auditors. This measure, however, is at present in the experimental stage, but if it proves satisfactory, it will be extended. The use of the firms' own auditors will not, of course, affect the department's right to make their own investigation subsequently, should this be considered necessary, but it is hoped that the report of the firms' auditors will in the great majority of cases be sufficient without further check.' "

The experience in Canada has been that while the impact of the war has brought about a very big demand for chartered accountants, the demand has been rather for individuals than for the services of the firms.

There have been a few cases where firms have been used, e.g.:

1. To act as controller for custodian of enemy property.
2. To act in certain government contracts to certify to capital costs or costs of production.
3. Enquiries for government departments such as Wartime Prices and Trade Board.
4. For a five-month period from May 1, 1940, twenty-one members of the Association were loaned by their firms to the Foreign Exchange Control Board to do special investigation work.

Even after two years of war, the situation of the relations between the government and the chartered accountancy firms may be regarded as still in an experimental stage. Government departments have shown that on the whole they prefer to have their own investigators, but experience may prove in the long run that a better result can be obtained if the government can put more responsibility on a firm's own auditors and take steps to prevent accounting firms from being depleted of their trained personnel for the benefit of government departments where their skill and training is not so fully used.

I venture to suggest that it rests with the accounting firms themselves to prove by their conduct that in the realms of accuracy, economy, and efficiency, their services can prove to be the most satisfactory, not only to their clients, but also to the authority that may be interested in the clients' affairs.

I am sure that raising the standards of the profession in such matters as were discussed before the committee on professional ethics the other evening will go a very long way towards improving our position before the public.

There is also something to be said about the point of view of the client. The other day one of my colleagues was asked to keep his men out of a client's office because there were already five sets of government auditors preventing him from getting on with his work.

One difficulty of the government is the danger of being accused of using political patronage in the employment of firms.

Regarding the relations between the government and the profession, I quote from a speech of C. Fraser Elliott, K.C., Commissioner of Income Tax, Ottawa, at the annual meeting of the Institute of Chartered Accountants of Ontario, February 28, 1941. Referring to the national-defence tax, he said:

Your "profession will, in the course of your usual duties, be required to certify as to the accuracy of the accounts of public corporate employers in the discharge of this statutory trusteeship duty, the same as you do for all accounts. But the point is, it is another of the cumulative duties of a tax character arising in the course of your duties and functions. The cost of compliance is mounting!

"There is every reason to believe that such trust and confidence as exists in the United Kingdom is developing in Canada. Such a trust is not created by a declaration. It is acquired by a course of conduct over a long period of time. It is not a thing given or taken. It is a thing that grows in the course of time. It is an understanding amounting to complete trust and reliance in the integrity, the honesty of purpose and ethical standards each of the other; further, that there prevails a steadfast purpose to adhere to such characteristics notwithstanding special pleas or inducements from any source to deviate therefrom.

"Our direct taxes are, comparatively, so very new, as also are some professional accountant associations, that it is perhaps too early to consider that we have attained to such perfection and mutual understanding as they have in England."

In Mr. Elliott's remarks there is a challenge to the profession which I think we should take up. I agree that it should be the aim of the profession to establish its position in the community so that the opinion of its members, once given, would not need any revision by taxing authorities or others. In order to bring about that result, it will be necessary for the government, in drafting its legislation, to see that the regulations regarding the preparation of statements by the taxpayers, as well as the precise definition of the tax liability in the various revenue acts, make it possible for the company's auditor to know that the tax obligations of the company are completely and properly stated.

To the company's auditor, faced with giving his opinion on the amount of taxes due from the point of view of the profession, there are too many matters left to the discretion of the Minister and too many references to such bodies as the War Contracts Depreciation Board and the Board of Referees under the Excess Profits Tax Act. An added difficulty is that the manner in which the Minister exercises his discretion is not made public.

Another most difficult problem under the income-tax and excess-profits-tax acts is the question of special inventory reserves. Apparently as a compromise, the government is willing to allow certain inventory reserves as applicable under the higher brackets of the excess-profits-tax act, but not as applicable under the income-tax act. To our profession, this seems inconsistent. It is hoped that some better formula can be devised which, while giving the government its proper share of the profits, will at the same time enable the taxpayer to keep his working capital intact and available for use after the war.

We all know that after the last war many businesses were in serious difficulties due to deflation in inventories. I have previously referred to the fact that the driving force behind economic activity is the profit motive. With the present high taxation in Canada, the Dominion government is even more interested in the benefit of the profit motive than are the shareholders of the companies themselves. The owners of the companies are, as a rule, quite willing that the government should take the bulk of the profits during wartime, but they do hope that when the war is over, they will at least have their working capital and fixed capital intact. If the stability of our industry is to be maintained, it seems to me to be very much in the interests of the Dominion government to see that when the war is over, industry in Canada is able to carry on.

Continued improvement of accounting methods can also save time to the taxpayer, his auditor, and the tax collector. May I make one suggestion concerning an ever present problem, the importance of which has increased greatly with the coming of war industries? I refer to the provision of depreciation reserves, and my suggestion is that all amounts reserved for depreciation should be represented amongst the assets by cash or the equivalent thereof in a depreciation fund, such funds to be used only when the asset on which the depreciation was charged was being renewed or replaced.

The increased work and the reduced staffs, particularly in the junior and intermediate brackets, have made it imperative that there should be no unnecessary checking or waste of effort on the part of the accountant or his assistants. Here again comes the necessity of better accounting methods, and particularly the extension of the principle of internal check wherever possible.

There is one other situation affecting business and our profession which, if dealt with, would result in a great improvement and tremendous saving of time and cost to everybody concerned. I refer to the report of the Royal Commission on Dominion-Provincial Relations which was submitted to the Dominion Parliament in June, 1940. This report dealt extensively with the complicated and duplicatory systems of taxation imposed on the business and people of Canada by the different governments—federal, provincial, and municipal—and made drastic recommendations, the implementation of which would bring about a tremendous saving to the taxpayer, as well as to the different governmental authorities, and the profit to the country would be enormous. While the Dominion government has offered to the provinces an opportunity for the duration of the war of partly putting into effect the recommendations regarding central collection of income and corporation profits taxes and some of the provinces have indicated their intentions of accepting the offer, that is only a small portion of the improvement that would take place if the proposals were fully implemented.

The problem of increased work combined with less well trained and often greatly reduced staffs, must in the office of the accountant be met with greater efficiency of organization—cutting down of waste time, careful supervision of audit programs and, when every other possible thing has been done, greatly increased overtime.

Senior members of the profession who have been looking forward to reducing their labors and responsibilities have had to turn their minds back and take on the struggle with increased tax problems and more complicated working papers. Mr. Chips has come into his own again.

The Philosophy Underlying the Changes Being Requested in the Securities Acts

BY EDWARD H. HILLIARD, LOUISVILLE, KY.

Vice President, Investment Bankers Association of America

As a representative of the securities industry, I am happy to have this opportunity to present to the annual meeting of the American Institute of Accountants a résumé of the point of view or philosophy which underlies the changes in the securities acts which are being suggested by the industry.

Your profession has a real interest in this subject. You are responsible for much of the material which goes to make up the disclosure which all of us so earnestly desire in connection with the sale of securities. In addition, you in your daily work see the results of successful and unsuccessful security investment in your clients' statements. Certainly you share with the Investment Bankers Association of America an intense interest in furnishing to every investor that substantial safeguard which fair and adequate disclosure provides.

Indeed, you may have a far deeper interest in this subject than merely as accountants and observers. The smooth and uninterrupted flow of capital into industry is vital to the American way of life, and to the preservation of our system of private enterprise. In the United States, this flow averaged some $3,500,000,000 annually for the ten years from 1920 to 1930. Since 1930, it has averaged only $700,000,000 annually. I make no charge that security regulation is solely or primarily responsible for this decline but it must be obvious to every thinking man that this flow of capital into industry, now so needed for defense, should be stimulated and accelerated by every possible means and not hampered unnecessarily by legislation of any type.

Designed to aid the private capital market by making it possible to transact business more efficiently while providing soundly for the protection of investors, various proposals for amendments to the securities act of 1933, the securities-exchange act of 1934, and the bankruptcy act were submitted to Congress on August 8, 1941, in two reports, one of which represents the views of the Investment Bankers Association of America, the National Association of Securities Dealers, Inc., the New York Curb Exchange, and the New York Stock Exchange, and the other those of the Securities and Exchange Commission.

For about a year prior to the presentation of the reports, conferences had been taking place from time to time between the Commission and representatives of the securities industry. Throughout these conferences the Investment Bankers Association has been represented by R. McLean Stewart, chairman of the securities-acts committee. The National Association of Securities Dealers has been represented by Nevil Ford and by Stewart S. Hawes. The New York Curb Exchange has been represented by George P. Rea, president, and Francis A. Truslow, of counsel. The New York Stock Exchange has been represented by Howland S. Davis, executive vice president, and Samuel L. Rosenberry, of counsel. Emmett F. Connely, John K. Starkweather, and your speaker, of the Investment Bankers Association, have participated in the conferences from time to time. Since his appointment as president of the New York Stock Exchange, Emil Schram has also participated in the conferences. Arthur H. Dean and Robert G. Page have acted as counsel for the Investment Bankers Association securities-acts committee, and Paul W. Frum as counsel for the National Association of Securities Dealers committee.

In their report, the representatives of the industry express their appreciation of the constructive character of the conferences and of the consideration given to their proposals by the Securities and Exchange Commission and by the members of the Commission's staff.

The representatives of the two associations and of the two exchanges have sought only to make the securities act of 1933 and the securities-exchange act of 1934 more equitable and to modify procedures under the acts so as to make it possible to transact business more efficiently without impairing the protection afforded to investors by the requirement of fair and adequate disclosure of information as to the character of securities offered or sold to the public. They have always supported the principle that the federal laws should adequately safeguard the investor against fraudulent transactions. So, in examining the existing laws and in suggesting amendments, the representatives of the industry have had as their objective changes which would facilitate the resumption of private investment and the flow of idle money into industry through the simplification of procedures and by the removal of those restrictive provisions, unnecessary for the protection of investors, which have impeded the exchanges and the private capital market from functioning efficiently in the public interest. The effort to increase the dissemination of information has been an important factor underlying many of these changes.

In order to understand the philosophy of these changes, it is necessary to review the philosophy and the operation of the 1933 act. Inasmuch as I am familiar with that act primarily, I shall refer to that more than to the 1934 act. That philosophy of the 1933 act was quite simple. In connection with the issuance and sale of new issues, it involved four steps:

(1) The preparation and filing with the Securities and Exchange Commission of a registration statement covering a wide range of information about the securities to be offered. In short, full disclosure of all essential facts.
(2) A waiting period of twenty days in which investors could study these facts and in which no sales or offerings could legally be made. In short, a waiting period to provide investors with information and to prevent high-pressure sales tactics.
(3) A date when the registration statement became effective when sales and solicitation could legally start, and
(4) The use of an official prospectus meeting the provisions of the act for delivery to the buyer.

Severe penalties both civil and criminal were provided for violation of these sections and the buyer of a security sold in violation of the act had the right of recision for a period running in some instances up to three years.

These steps do not seem complicated. They actually seem very logical. Why, then, did not this scheme work? We must examine and understand the reasons for its shortcomings because this failure is responsible for a change in the philosophy underlying this act, namely, that the filing in Washington of complete information is not enough, that there must be dissemination of information if investors are to be protected and capital is to flow unimpeded into industry. This thought underlies some of the major changes suggested by industry. In one sentence, this part of the present act failed because, while it accomplished the preparation and filing of complete information, the character and severity of its penalties effectually prevented the dissemination of that information to the great majority of investors. The waiting period was provided so that investors could read and digest the information about a security under consideration. The dealer who during the waiting period "informed" his prospect was under no liability, but the dealer who by mail or interstate telephone during that period solicited a prospect, laid himself open to severe penalties—fines, imprisonment, and recision in case that prospect made a purchase after the effective date of registration. Where does informing a customer become solicitation? When the spoken word is in question, who actually knows? Even when the act of "informing" a customer about a forthcoming issue is in writing, there is grave doubt as to when it becomes solicitation. The Securities and Exchange Commission through its counsel, Judge Burns, in its release No. 464 in 1935, said this in connection with the distribution of statistical service bulletins about a security during the waiting period: "The intent with which the bulletins are used, as determined from all surrounding circumstances, would control the legality of circulation thereof by underwriters or dealers." Further, the same bulletin said: "If an underwriter or dealer were to supplement a bulletin with selling literature or with a recommendation to the recipient as to the desirability of purchase, or were to attempt to obtain from the recipient some indication of interest, however tentative, in purchasing the described security, such action, in my opinion, would almost conclusively establish that the bulletin was being used in an attempt to dispose of or to solicit an order for the purchase of the security."

If a dealer during the waiting period mailed one of these bulletins and his client voluntarily called up and indicated that he might be interested, had the dealer solicited an order?

The whole difficulty arose because the act defines "sell" to include an offer to sell. During the waiting period it is unlawful to sell and, therefore, unlawful to attempt or offer to sell. We must remember this because the industry feels that it is absolutely essential to distinguish between selling and offering to sell if the dissemination of any information to the great body of investors is to be carried out in the spirit of the act. When I come to a discussion of the suggested amendments, I shall return to this point, but before leaving it now I would like to point out the unhappy results it produced.

First, in the daily conduct of our business, dealers were not infrequently involved in that vague middle ground between informing a client and soliciting him. Clients, especially trustees, bank officials, and larger investors required and expected the assistance of investment dealers in their study of the merits of forthcoming issues. Dealers for their own guidance prepared elaborate statistical comparisons and other analytical studies. Dealers not only showed these studies to their larger clients but not infrequently discussed with their larger clients the merits of the issue, and the client in many instances voluntarily did give that "indication of interest" referred to in Judge Burns' opinion. But while this effort to inform larger clients went on during the waiting period, there was dead silence in so far as the small and less well informed investors were concerned. Because of the fear that circulation of information during the waiting period might be held solicitation or making an offer to sell, these analytical studies were not circulated generally among investors. The small investor who most needed help got no information and had no chance to study comparative figures. The informed investors, especially the professional trustees and the large institutions, who are best able to take care of themselves, got all the information and analyses in the dealers' files.

We have just seen how the dissemination of information was made very difficult during the so-called waiting period. What happened after the effective date, when sales and offers to sell could lawfully be made? The average length of a prospectus was 41 pages. Not infrequently they were 75 to 100 pages long. It was not a readable document. It required long and almost expert familiarity with the subject to find in the average prospectus such simple and essential information as a statement of capitalization after the current financing or a statement of interest coverage on the new securities. But how get this information, this voluminous document, into the hand of the prospective investor? Mailing a prospectus to a general mailing list was expensive—about 25 cents a customer—and if mailed would it be read? The law did provide for distribution of a circular merely giving the title of the issue, the price, and where a complete prospectus might be obtained, but this circular with its lack of information had the tendency to kill any investor interest in the offering, and promptly became known as a "tombstone." With the coöperation of the Securities and Exchange Commission the preparation of a short or newspaper prospectus giving the salient facts was undertaken, but the use of these newspaper prospectuses otherwise than as newspaper advertising were prohibited. If mailed to a client, that act created severe liabilities unless the complete prospectus had previously been given to that client. Thus, in spite of the fact that fair and adequate information on an issue was available in the form of a prospectus, the average prospect did not receive this information and many of those who did could not analyze the information sufficiently to aid them in coming to a decision.

So much for the dissemination of information on so-called new securities—those requiring a prospectus meeting the terms of section 10. What happened on outstanding securities—the so-called old securities traded in on the exchanges and in the over-the-counter market? With the exception of certain exempt securities such as municipal and other government obligations, the act made any statement about these securities—written or oral—a prospectus, and if used in making a sale or in soliciting an order created grave liabilities including the right of recision in case there was a misstatement of fact or a material omission. Prior to the passage of the securities act, dealers in securities made available to their customers analyses of outstanding securities, which analyses were designed to give an investor the salient facts with respect to a security. These analyses did not purport to contain all relevant information, but were clearly marked "outlines" or "summaries." In many instances, comparative data with respect to various other securities were made available. This dissemination of information was important for two reasons. It was valuable in itself. These outlines were educational. Through them thousands of investors learned something about security analysis. Comparative figures on bonds, for instance, showed the ratio of debt to gross, the ratio of debt to property values, maintenance, and depreciation charges as a percentage of gross, the per cent of gross available for interest charges, interest coverage—all very simple and elementary to the expert investor but highly valuable and educational to the average investor. My firm, prior to the passage of the securities act, issued such summaries at frequent intervals. One month we would take twenty "AAA" bonds and, without any recommendation, include such statistical information as above. Another month we would take twenty "AA" bonds and do likewise. I never realized the value of these analyses to our clients until one day a businessman in Louisville told me that his study of the figures on the "AAA" group and those on the "AA" group first suggested to him what to look for in an effort to distinguish quality in bond investment. The educational value of these statistical summaries was and still is most important but there is another factor not to be overlooked. No one can deny the fact that the great list of seasoned securities traded in on the stock exchanges and in the over-the-counter markets of the United States include the finest investment securities in the world today. No one is paying a dealer or an underwriter a fee for calling attention to these securities. The broker or dealer handling them must rely on the small commission or the small spread to cover his expense and provide compensation for his time and effort. On listed securities, this commission is not only small but frequently has to be divided with another exchange member who does part of the work in executing the order. Investment orders generally do not involve large amounts, and in the interior of the country average very small indeed. The smaller the investor the sounder his investment should be, and seasoned securities should have a very definite place in his list. But no broker can afford to send a salesman to call on a small investor to get an order to buy one thousand dollars' worth of General Electric or to purchase one American Telephone & Telegraph bond. Contact with that investor and all other small investors must be made by mail and must be made economically if the broker or dealer depends on his small commission or profit in handling seasoned issues.

Actually that broker or dealer cannot afford to solicit such orders even by a single letter. Orders must flow to him because through the years, by sound advice and simple informative material, he has built up a clientele which almost automatically turns to him whenever the question of investment comes up.

Since the present statute became law, many brokers and dealers have not found it possible to send out this informative statistical material. These men were not afraid of the liability for misstatements. They were perfectly willing to stand by the accuracy of their statements, but these summaries were by their very nature incomplete, and much material had to be omitted. Just what was a material omission and what might be a material omission in the light of events a year or two hence? Furthermore, these circulars were prepared by reference to the standard statistical manuals. The broker or dealer had no access to the books of the corporation and could not ascertain if all the material information was included in the reference manual. Let me give you an interesting example of a material omission. One of the best known reference manuals contained in its 1939 issue exactly twenty pages about the Louisville & Nashville Railroad. Had any dealer or broker made a summary of this material or indeed copied every word of these twenty pages and recommended the purchase of the L. & N. Refunding 4½'s of 2003, the buyer unquestionably would have had the right of recision because of the omission of a material fact.

It *is* sound and highly desirable to have no omission of material facts, but under the present act the penalties are so severe and the use of the greatest care in preparing such material is of such little avail in defense that financially responsible houses generally no longer send out this material to the average list of small investors. Again, large investors, trustees, bank officials, and others who not infrequently have their own sources of statistical information receive these outlines and summaries on seasoned securities; but the small investor, the man who most needs seasoned securities in his list and who has no statistical manuals on his desk, receives nothing. Thousands of small investors are cut off from the type of contact they need most and are left to the tender mercies of the promoter-salesman—the man who can afford to drive ten miles, make one call, and get a ten-share order with three points profit.

There is one phase of this situation on which there has been very little comment. The New York Stock Exchange list includes many of the finest investment securities in the world. We are in an investment market today. When and how is the attention of the average small investor called to this list? In the Louisville district we know there are 15,000 occasional investors. There may be 25,000 or even 30,000. Apparently after allowing for duplications, statistical summaries, or outlines, comparative analyses and other informative material is being sent by brokers and dealers to only about 2,000 names (mostly institutional and larger investors) and the remaining 13,000 (or 28,000 as the case may be) receive no informative material about the best list of investment securities in the world. In fact, because stock exchange members no longer send informative material to these small investors, some of these small investors think that stock exchange members are not interested in small-investment orders. I make this statement because one down-in-the-state investor—a former client of ours—once said to me "I did not know you stock exchange members were interested in small-investment orders—I never get any circulars from you any more."

Again we come to the underlying philosophy of full disclosure. The restrictions on deceptive disclosures must be severe and effective but the flow of honest and informative material, especially to the small investor, must not be stopped. I repeat, the preparation of complete information is not enough, and the important point underlying the changes suggested by the representatives of the industry involves the dissemination of information to the investor. In my personal opinion, all the other changes are minor. There are revisions and clarifications on other points but I say to you that unless the main objective—the dissemination of information—is accomplished, our efforts have been far from successful.

Just how does the industry propose to improve the situation? Our objective is to put information in the hands of the investor and we advocate five substantial changes in the act.

First. The industry proposes a change in the title of the act, to read as follows:

"An act—To provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, *with the least possible interference with honest business*, and for other purposes."

This proposal has been accepted by the Commission.

Second. The industry and the Commission propose to simplify the presentation of information in prospectuses and to reduce the size of the general prospectus. If the Commission by order specifically authorizes the omission or condensation of information, no liability shall attach to any issuer or underwriter by reason of such omission or condensation unless the order itself was obtained on the basis of an untrue statement (Sec. 10(6)(3)).

Third. By distinguishing between a sale on the one hand and an offer to sell or solicitation of an offer to buy on the other, to make it possible for a dealer to put into the hands of his client information of great value in determining whether or not he wants to buy, and

Fourth. To provide that any solicitation prior to the effective date must be by means of a written document. There can be no sale prior to the effective date but, if such solicitation results in an order to buy, the client shall have after the effective date for a period of twenty-four hours after he receives the full prospectus and before he pays for the security, the complete right to say that he elects not to proceed with the purchase. In practice, in most instances, this written document referred to above would be a "limited prospectus" as provided in the act, carefully prepared and subject to section 11 liabilities. It would be possible for dealers to obtain these prospectuses and to inform their customers, large and small, of the general characteristics of the forthcoming issue. If the customer is solicited he is fully protected by this right to say that he elects not to proceed with the purchase. On the confirmation itself, in such form as the Commission may prescribe, it is to be stated that the sale shall not become effective if the purchaser, not later than noon on the first business day after the day on which such written confirmation was received by him or at the address specified by him, advises the seller that he, the purchaser, elects not to proceed with the purchase. Furthermore, the representatives of the industry recognize that if offerings of securities are to be permitted prior to the effective date of a registration statement, it is desirable to provide certain new safeguards to ensure that all essential information contained in the registration statement and final prospectus shall be made available to the purchaser before he enters into a binding sales contract during the first few days after the effective date. The proposed section 5(a)(3) establishes such a procedure. It requires that during the first seven days of public offering after the effective date of a registration statement, no sale of a security may be made unless—

(a) A general prospectus is sent or given to the purchaser so that it would normally be received by him on the day before the day on which the sale is made; or

(b) If a general prospectus is not given to a purchaser prior to the day when a sale is made, the purchaser must, not later than the next business day, be sent or given a prospectus and a written confirmation of the sale telling him that he has an absolute right of cancellation if, not later than noon on the first business day after the day when he receives the written confirmation, he advises the seller that he has examined the general prospectus and that he elects not to proceed with the purchase.

There has been a great discussion within the industry about the amendments to section 5. Many investment dealers feel that, in an effort to protect the investor and to continue the safeguards thrown around him by the present act, the industry has made proposals which in effect give the buyer an option which he may elect not to exercise. There is much to this thought but certainly it is sound policy to give to the investor, who prior to the effective date has been approached on the basis of the limited prospectus, the opportunity to study the full prospectus and then to decide whether or not he desires to go ahead with the purchase.

While many in the industry criticize this procedure for going too far in one direction, the Securities and Exchange Commission thinks it goes too far in the other direction. This is a source of keen disappointment to those of us who hoped for general agreement on this troublesome point. This is not the time nor am I able to present the arguments of the industry for these proposals and the arguments of the Commission against them. Both are covered fully in the respective reports on the amendments. In this brief paper, I have endeavored to give you the philosophy underlying the proposals needed by the industry. These proposals are not made in an effort to undermine the real purposes of the act. It is hard to solve this problem of putting adequate information in the hands of the investor in such form and at such time as to help him to make a sound decision. The Securities and Exchange Commission itself has expressed its willingness to approve certain of these changes if no sale and no contracts of sale take place before the effective date and if, after the effective date, the purchaser receives a complete prospectus twenty-four hours before he contracts to buy. The industry honestly differs with this suggestion and we have pointed out that this procedure would practically eliminate purchases of the most attractive issues by interior investors, especially small country investors. The small investor would have time to get a prospectus on a "slow" offering but never one on a good offering.

Fifth. It is proposed to amend section 12 and to recognize that conditions surrounding the handling of old securities differ from those surrounding securities subject to registration. These amendments should prove helpful in enabling brokers and dealers to give their customers informative summaries without assuming undue liabilities with respect thereto. The statute would, however, continue to impose liabilities fully adequate to ensure that the dealer act in good faith and with reasonable ground to believe that there was no untrue or misleading statement in the information supplied by him.

In my opinion, possibly this proposal, which is concurred in by the Commission, will actually prove of great importance. First, it most directly involves the philosophy behind all the suggested changes—that all requirements that information be complete, that all information be accurate, that there be no material omission—all of this is in vain unless the essential information reaches the prospective buyer in such form and at such a time as to be a guiding force for him in coming to his decision. Second, it involves far more thousands of investors than any other section of the act. Finally, it recognizes that requiring too much "completeness" of information may actually result in no information at all for the small investor. It seems to me that the dissemination of information on securities, old and new, is closely connected with the flow of capital into industry, and that is what we all want.

I sometimes like to think of this flow of capital into industry as a great highway with an immense volume of traffic. That traffic is money going to work—the life blood of our private enterprise system. Always there is some reckless driving on this highway and we should make conscientious efforts to stop it, because reckless financial driving, like reckless automobile driving, produces wrecks and casualties. But we must recognize that if every automobile driver had to stop at every corner and have his driving tested and his reactions measured, traffic on this highway would be slowed up and in fact many honest and efficient drivers might stay at home. And so it comes back to the philosophy underlying the proposed changes in these acts. The securities industry wants to see fair and adequate disclosure—the prevention of fraud in the sale of securities with the least possible interference with honest business. It wants to see to it that the essential part of the voluminous information now compiled in a registration statement reaches the investor, and it wants to make it possible for the honest broker and dealer to give his clients, especially the small investors, information about the seasoned securities which comprise the outstanding investment securities in the world today. Then will the flow of savings into industry be accelerated and then will our production grow—for defense in time of war and for a better standard of living in time of peace.

VII

Better English for Accountants

Chairman: ROBERT P. BRIGGS *September 15, 1941*

Better English for Accountants

BY CHESTER R. ANDERSON, CHICAGO, ILL.
Associate Professor of English,
University of Illinois

DISCUSSING how to write perfect English in thirty minutes is like teaching piano playing in six easy lessons. Some lessons are never completely mastered. No one plays a perfect game of tennis or writes perfect English. It seems presumptuous to criticize in others a fault which exists in ourselves, but perhaps the presumption may be excused if it results in helping writers. Many mistakes can be automatically avoided if people are simply made conscious of shortcomings or are impressed with the importance of good English.

Because of this subject on your program and because of my work with accountants, I know that you are interested in English. So much so that I want to clear my subject of certain implications. Lest "Better English for Accountants" imply that all English written by accountants is bad, let me hasten to say that this is not true. I have found good and bad English in accounting literature. Some of the bad is caused by legal restrictions more or less beyond the individual accountant's control. But, more important, I have found among accounting leaders a definite interest in and desire to improve the English of your profession. Speaking as a teacher, I can report to you that your interest in and insistence upon better English among accounting students is immeasurably helpful. To be able to point to some article in an accounting journal and say to a class, "Here is what your future employers think of English," has a most salutary effect.

Until you began insisting upon better English, accounting students tended to follow the engineers' old slogan, "Us Engineers' don't need no English; we was born in the U. S." Happily both groups under farsighted leadership are now recognizing that expression is power in their respective professions—that they need to handle pen and pencil with equal facility.

Writing is an integral part of business training for a hard and exacting world. As Bacon said:

> "Reading maketh a full man;
> Conversation a ready man;
> Writing an exact man."

A man's English determines his educational level; it is an index to his mind. C. F. Kettering says, "Success depends as much on ability to present an idea convincingly as an ability to perform calculation or experiments. You may perform the most miraculous experiments in the laboratory. Yet you have not contributed anything to the advancement of knowledge until you have transmitted your results to others."

Good English is a training in thinking, a groundwork for effective expression, a link between professional and human interests, a necessity in business, cultural, or recreational pursuits.

Of course, if one's thinking is hazy,

the best English will not help it. But as someone has so aptly said, the language must not be liable for damages inflicted upon the thought in transit. It is necessary to add rhetoric to logic to secure interest and to control peoples' reactions.

Business writing, perhaps better known as business English, is simply clear business communication—rational and sometimes emotional. In the curricula of our larger universities, business writing is almost a perfect vehicle for teaching both the content and the style of written business relationships. To quote Professor R. R. Aurner, University of Wisconsin, in his presidential address to the American Business Writing Association:

"Business writing has an ancient ancestry. In 1568 came the volume by William Fulwood, *The Enemiee of Idlenesse*, which has been called the first book on business correspondence, largely based upon the fact that it is the first 'letter writer' recorded in the Stationers' Register. Fulwood defined his subject thus: 'And to describe the true definition of an Epistle or letter, it is nothing but an Oration written, conteining the mynd of the Orator, or wryter, thereby to give to him or them absent, the same that should be declared if they were present.'

"Eighteen years later . . . Fulwood's book is appearing in its fourth edition and Angel Day has published his *English Secretary*, a work which proves to be even more popular than Fulwood's volume. Going back to the classical rhetoric, Day points out that for the orderly and elegant expression of any matter certain precepts must be followed for 'framing an epistle.'

" '. . . firste, aptnesse of words and sentences, respecting that they be neate and choiselie picked, and orderly handled: next, brevity of speach, according in matter and circumstance fitlie to be framed: lastly, Comeliness in deliverance, concerning the person and cause, whereupon the direction is grounded.' "

This is sound advice for 1941. But for more modern advice, let us look at Professor Aurner's quotation from Dr. Ralph Starr Butler of General Foods Corporation directed toward the present-day business student:

"A student who passes through elementary school and secondary school may have devoted one quarter of his entire school experience to the study of English, and few college students can escape at least one year of instruction in English. If all this emphasis on English bore proper fruit, we should expect the schools to turn out a highly literate product. As a nation we ought to excel in accuracy and effectiveness of expression, as well as in an intelligent appreciation of literature. As a matter of fact, I am afraid we cannot point to these desirable results of the teaching of English.

"There may be reasons for this lack of results. I should like to point out one reason that is seldom given. Although teachers know why they teach English, the great majority of students do not know why they study it. Or at least, they so fail to relate the study of English to their personal interests and prospects that too often they approach the subject with distaste and leave it with pleasure. For such students let me provide a point of view.

"Of all the subjects that are studied from the first grade through to the end of an academic college course, English is the most practical. Skill in the use of English is almost the only skill that a student can take from an ordinary educational course that has a definite bread-and-butter value in after life. No other kind of skill acquired in school makes a more important contribution to the solution of earning a living.

"This is equally true whether the living is earned with the hands or with the brain, whether in a profession or in the great field of business. Speaking for business only, I cannot too strongly urge the fundamental importance of English in any course of training. The young man or woman in business who can speak and write accurately, clearly, and forcefully has an enormous advantage over the one who lacks this equipment."

That the teaching of English has not improved since the gradual death of the classical languages in our schools and the substitution of so-called modern subjects and sugar-coated teaching, there can be little doubt. Certain things have to be learned and done the hard way. The study of English is or should be as meticulous as the study of accounting. You don't try to gloss over your method of teaching there.

Many colleges are now trying to meet the need for better English by giving business writing courses devoted to letters, reports, direct mail, or business-magazine articles, and these have proved excellent motivation for better English teaching. These courses permit the student to write in fields in which he has interest and knowledge, they hold him to high standards of writing, and they give added hours of practice beyond the freshman year.

My pet theory of teaching writing to the average student (not the English major) is to let him handle subject matter with which he is familiar and in which he is interested, and then make him practice—plenty. Since every alumni survey ranks English at or near the top of lists of subjects that have been most helpful, I should like to see two hours of required writing each year (to be taken in either the first or second semester) beyond the freshman year or, in other words, six hours of writing beyond the usual freshman courses (when the student has little interest in writing and has nothing to say) distributed evenly through the last three years so that continued practice would develop facility. I'll admit that there is a budgetary problem involved, but if English is so important to the educated man, the money had better be spent on this and taken from subjects not ranked so high on the "most helpful" list.

What is business English? Some say there isn't such a thing. Perhaps there isn't. It is just ordinary, good English concerning ideas in a specialized field. The only difference between literary and technical writing is in purpose—not in the tools used. Business writing is for impression while literary writing is for expression. Business writing has an immediate purpose. It fits well Stevenson's, "not to write, but to write what you mean; not to affect your reader, but to affect him precisely as you wish."

It fits well Fulwood's definition of writing "conteining the mynd of the Orator," and it is the best vehicle yet found to answer Dr. Butler's correct statement that students fight against ordinary English instruction.

In making suggestions on better English for accountants, I have nothing to offer but sweat and tears, to quote Mr. Churchill. I am not sure about the blood. Writing is hard work. It requires imagination, wide knowledge, a sense of organization, concentration, and patience—patience to learn slowly. English doesn't spring up over night any more than a certified public accountant. Writing means practice and revising—murdering many brain children. But "hard writing makes easy reading"; economy for the reader is not the easiest way for the writer; short cuts, gaps in reasoning, and the easy word are marks of the writing hitchhiker.

Good writing is simple and direct. It cuts to the core and discards the superfluous and complicated. It is simple enough for the janitor to understand. Fine writing is not required, but specific, concise, vivid writing is necessary for accuracy and brevity. The old small-town editor's salty advice is worth a thought:

"In this office we do not commence, we begin. We do not peruse a book, we read it. We do not purchase, we buy. We have no souvenirs, we have keepsakes. A spade is called a spade.

"In this town we do not reside in residences, we live in homes. We do not retire, we go to bed. We do not pass away, we die. We have no morticians. We are not all gentlemen, but we are all men. All women are not ladies, but all women are women. All women are females, it is true, but dogs, horses, and pigs can also be females. Hence, in deference to our women, we do not class them as mere females.

"Our priests, ministers, and rabbis are not divines. Our lawyers are not barristers. Our real estate dealers are not realtors. Our plumbers are not sanitary engineers. No beauticians live here.

"All fires, remember, are not conflagrations. All testimony is not evidence. And if any reporter writes of a body landing with a 'dull, sickening thud,' he will land on the sidewalk with a jolt, his hat in one hand and his pay envelope in the other."

A writer must not give his reader two sets of complexities to unravel—those of his subject and those of his language. Inappropriate language deceives only the ignorant.

Good writing is the result of correct data, careful organization, accurate English, and meticulous mechanics. I assume that the accountant always works with correct data. The fact that you have something definite to say is half the battle. Many so-called writers unfortunately have nothing to say, and consequently have trouble saying it.

Orderly communication of ideas is wholly dependent on a definite plan. Careful organization means outlining, arranging material in the proper order of importance to the reader. Topic and summarizing sentences will aid the reader, especially in long pieces of writing. Items with special news value should be emphasized by position and space. Journalism may be anathema to the accountant, but a study of journalistic methods of writing is profitable. A man who can write a journalistic lead, who can pack his first sentence with the gist of the story, who can subordinate the writer to the reader—that man will have directness and interest in his writing. For instance, if an audit uncovers a serious shortage, that will probably be the most important thing in the comments and should not be buried in chronological order somewhere near the end of the discussion.

Before writing your report, go over your notes like the journalist and ask yourself, "What are the news and human interest values here? What will the reader want most to know?" Then in your organization of material arrange to give those points emphasis. "We counted the petty cash" is probably a trivial, uninteresting, routine lead for a report. But "Earnings increased 23 per cent during the past year" gives promise of dividends to all interested readers, and emphasizes results rather than methods.[1]

Good English means adaptation and personality as well as accurate diction and construction. For effective presentation, all business writing, especially accountants' reports, should be adapted to the

Reader's point of view
Reader's experience and knowledge
Reader's method of thinking
Nature of the subject matter.

The man who is going to open a mine will have a different point of view from the man who is going to invest in one. A report on tractors for a farm group will not have to spend so much time on the general need for tractors as if the report had been made twenty years ago. The bankers' or brokers' method of thinking concerning bonds makes it possible and desirable to use technical financial terms.

For a reader whose method of thinking is ultraconservative, a report must be tactfully written if it is trying to change a current practice. For the executive who makes quick decisions, the report will have to be adapted in tone and organization.

All this implies two needs of good writing—adaptation to the reader and personality in the writer. Every piece

[1] Saunders and Anderson, *Business Reports*, 2 ed. McGraw-Hill Book Company, Inc., 1940, pp. 309–11.

of writing is an extension of the writer's personality, the quality of which is governed by the ability for effective presentation. Better English, then, is better expression of ourselves. The man with chronic dyspepsia hasn't much good to reflect in his writing.

Today we have a new frontier of business writing. Companies are beginning to realize that business writing is the last link between work done and final approval. They realize that all written work represents the personality of the company and are reviewing their written English with renewed and heightened interest. Companies that spend much money in high-powered public relations are no longer permitting themselves to be represented by churlish, stupid letters and reports. The written work received from a company represents that company to the reader. The employee who wired an impatient customer, "Keep your shirt on; others want our stuff too," *was the company* to that man—and the company lost a customer. Why business will spend enormous sums on advertising and then trust the direct, delicate personal contact with the customer to untrained—and often illiterate—correspondents is incomprehensible. A man may hurt his firm's prestige by being ungrammatical, but he can ruin it beyond recall by saying, "We aren't accustomed to such unfair treatment." Report writers often assume the attitude of policemen instead of service men.

That training correspondents can be done is evidenced not only by a few outstanding companies but by the government department of agriculture which has reduced letters sent back for correction from 8 per cent to 2 per cent, while immeasurably improving the contents.

One of the greatest enemies of personality in writing is jargon. There are two kinds of jargon. First, the cliché, or "in a rut" variety, that inexperienced writers are afraid to leave. Second, the high-sounding, wordy, or pompous variety that wastes the time of the reader and blurs the effect.

The first you will recognize from this bit of doggerel:

We beg to advise you, and wish to state,
That yours has arrived of recent date;
We have it before us, its contents are noted,
Herewith enclosed are the prices we quoted.
Attached you will find as per your request,
The sample you called for; and we would suggest
Regarding the matter and due to the fact
That up to this writing your order we've lacked,
We hope you will not delay it unduly,
And we beg to remain, yours very truly.

That kind of writing belongs to a vanishing frontier. Slavishly following last year's model and even last century's model is not only deadly but often unclear to modern readers. The law is a good example of unintelligible tradition in writing.

Analyze a few of those expressions. Flood them with the cool light of reason. "We beg to advise." The *we* beginning counteracts any you-attitude you are trying to develop; you're not in the *begging* business—or you need a tin cup; and seldom are you correctly *advising*, unless you are a lawyer. "Wish to state." A pure waste of words. Say what you want to, and the reader will guess that you "wished to state it." In short, get to the point, if you have a point. "Herewith enclosed." One is enough. No need for the repetition. "We hope." This is part of that famous triumvirate of weak sisters—hope, trust, and if. They all imply doubt and hence are weak words, especially for endings of letters. And we'll let you "remain." Don't advertise that your business is so unstable.

The personality expressed in such writing is stereotyped and unnatural.

The writing is unreal, unclear, and expensive because it can all be rewritten in fewer words. The effect is nullified by constant repetition.

You wouldn't talk that way. Why write that way? Lest that kind of writing creep into the conversation, remember that when the man who dictated fussy, rubber-stamped letters all day was invited to dinner and asked to say Grace, he delivered himself of this:

"Dear Lord," he began, "We thank Thee for all Thy favors of recent date. Permit us to offer our heartfelt gratitude and appreciation of your valued consideration. We sincerely trust that we may continue to merit your distinguished confidence and that we shall receive many more blessings from you in the future. We beg to remain, yours—er—Amen."

And there was the man who thought these absurd rubber-stamped phrases sounded pompous and polished, and tried them at home with this result:

Wife: Have a hard day at the office?

Husband: In response to your query of even date as to my day at the office, regret to say that business matters were pressing and I am very tired.

Wife: Well, come on now, dinner is ready.

Husband: In re your statement concerning immediate preparations to serve dinner, beg to advise that it will be five minutes before I can act on this, due to the fact that I have just lighted a cigar. Regretting my inability to comply promptly with your request, and trusting that the delay will not seriously inconvenience you.

Wife: (peering sternly over her glasses) Come to dinner! It's getting cold!

We wouldn't talk that way. With certain allowances for the written word, there is no more reason to write that way. For these overworked phrases, good writers substitute fresh, original sentences, tailor-made for the occasion. It requires more thought and better command of language, but the result is worth the effort.

The second kind of jargon is a more insidious type, embracing such words as "case," "instance," "character," "nature," "in order to," "in connection with," "in regard to," "due to the fact," "the above statement."[2]

None of this jargon is accurate; it is only approximation. It wastes time and space, costs money, and makes for ineffective presentation. Instead of shortening writing it lengthens it and destroys naturalness and vividness.

"The work is of a very uneven character." The work doesn't have *character*, *uneven* is vague, *very* adds nothing and should be used not oftener than once a month, and the sentence as a whole is so abstract that it leaves no definite picture or idea.

Here are some more sample sentences that contain more pork than a rivers-and-harbors bill.

Not: The discussion with regards to the P & L statement—
But: The discussion of the P & L statement—
Not: In case the expenses are reduced—
But: If the expenses are reduced—
Not: In the majority of cases—
But: Usually—
We take this opportunity to extend—(We extend)
It is obvious, however, that all these—(All these)
May I be granted the privilege of discussing—(May I discuss)

Condense, condense. Go through your work and blue pencil words, phrases, and sentences that are just padding. We all write too much. There is too much written in the world. Witness some of the modern 1400 page books. It is my idea that if a man can't express his idea in less than 1400 pages, he doesn't have an idea, he has a nightmare. Words, words,—that tell less than a presidential news conference.

[2] See Sir Arthur Quiller-Couch, *Art of Writing*, chapter on Jargon.

There might be some criticism in this bit of doggerel entitled:

Qualifications Gone Mad

We have audited this balance-sheet and
say in our report
That the cash is overstated, the cashier
being short;
That the customers' receivables are
very much past due;
That if there are some good ones they
are very, very few;
That the inventories are out of date and
principally junk;
That the method of their pricing is very
largely bunk;
That, according to our figures, the
undertaking's wrecked,
But, subject to these comments, the
balance-sheet's correct.

Perhaps these typical sentence errors, with revisions, will strike a suggestive note:

We wish to express our appreciation of the courtesies and coöperation extended to our representatives during the course of the examination.

We appreciate the courtesies and coöperation—

Replying to your inquiry made of us yesterday, we wish to say that the treatment of bond discount in your balance-sheet which you suggest would be satisfactory with us and would not necessitate a qualification in our certificate.

(Wordy, hackneyed, lack of emphasis)

The treatment of bond discount in your balance-sheet which you suggested in your letter of August 14, is satisfactory and will not require a qualification in our certificate.

We are in receipt of your letter of June 19 enclosing your Memphis branch report for which we thank you.

(Wordy, awkward, lack of emphasis)

Thank you for the Memphis branch report enclosed in your letter of June 19.

(Wasteful practice of repeating or paraphrasing unnecessary material)

We have your letter of May 23 and know that your buildings are mortgaged to secure a $10,000 loan; that you owe officers $2,000 in back salaries; that you are indebted to former stockholders on unsecured notes in the amount of $5,000; that your general manager's eyesight is failing and he can no longer handle his work efficiently. Under the circumstances we suggest—

Under the circumstances outlined in your letter of May 23, we suggest—

(Weak idea at the beginning of the sentence: needed information not complete; trite, negative phraseology; we-attitude)

In response to your recent request we regret to inform you that the 1941 U. S. Master Tax Guide is not available for distribution from this office, but is circulated by local field offices.

The 1941 U. S. Master Tax Guide may be obtained from your local field office at Blank Street, Chicago, Ill., for $1 a copy. We do not distribute from this office.

I believe that these revisions, while not perfect, are more concise and have better emphasis and tone. They are thrifty but not stingy with words. They are not like Old Willie: "Trouble with Old Willie is that he lies some. Y'see, he talks all the time; and there ain't that much truth in the world."

Conciseness is a virtue in good writing. "Jesus wept" is far more expressive than the modern divine's elegant version, "The Creator of the Universe burst into a flood of tears."

Since all writing must start with precise words, power over words is necessary for commanding, persuasive writing. Words are the tools; to attempt to write well without an adequate vocabulary is like trying to build bricks without straw.

Unfortunately the American people are too lazy to study their own language. They catch a new word here and there in periodicals, guess at its meaning, probably pronounce it incorrectly —and rush to the movies for an easy lesson in history. Few homes have dog-eared dictionaries, unless it is from the ravages of time alone.

Yet tests, such as Dr. Johnson O'Connor's, have shown that the most successful businessmen have unusually large vocabularies, sometimes beating out the college professor. Men who look to words as part of their stock in trade attempt to add to that inventory and to define meanings with the meticulous care given to auditing books, because they are broadening their horizon of a world in which to make a living and in which to live. In addition to forming the dictionary habit, I should recommend reading good books, many books. Read about fifty books and see how your use of words improves. Don't just scan a book, thereby losing its mode of expression, but read to absorb style. Good readers have a chance of becoming good writers. Poor readers are always poor writers. Incidentally, more college failures than you would think are the result of the inability to read with speed and understanding.

A moment ago I said that the American people were too lazy to study their own language. I meant both writing and speaking. You know that today the accountant has varied associations. His speaking is often as important as his writing. Incorrect pronunciation, affected accents, colloquialisms, not only cause educated associates to arch an eyebrow but may actively antagonize. Careless speech can be corrected by a combination of the dictionary habit and self-discipline.

My subject necessarily combines the cultural and the practical. They are not antagonistic. They are closely interwoven in modern business. That may sound idealistic, but an ideal is only an idea perfected, and certainly better English is a practical ideal. Some of the greatest leaders in business today have a wide and varied cultural background in literature, art, music.

And so I have no hesitancy to close on a timely cultural note. It is easy to underestimate the arts in time of stress —industrial and military preparedness —and to curtail certain educational activities. As Alexander Cowie said in a recent *Saturday Review* article, remember in such a time that books may be as important as bullets. Leaders do not spring up over night. They are trained, and a long preparation lies behind the man who suddenly springs into leadership. Education in the arts and humanities is a necessary training for leaders. Right now the world is waiting for the man who can present a better phrased set of war objectives. The writings of Adams, Franklin, John Dickinson, and Tom Paine were as important to the Revolutionary War as the muskets. The arsenal is no stronger than the leaders who can sway men. Churchill's command of language, more than of facts, has lifted the British heart.

America needs leaders; will always need trained leaders. Their training must be provided now for the future, and in their training the arts will be important. This program implies more than Better English for Accountants, perhaps, but better English cannot be overstressed, because it is the one basic mark of the leader which applies equally to all fields.

AMERICAN INSTITUTE
OF
ACCOUNTANTS

BY-LAWS
AND
RULES OF PROFESSIONAL CONDUCT
(as revised Jan 6, 1941)

1941

13 EAST 41ST STREET, NEW YORK

BY-LAWS

OF THE

American Institute of Accountants

ARTICLE I

NAME AND PURPOSES

SECTION 1. The name of this organization shall be The American Institute of Accountants. Its objects shall be to unite the accountancy profession of the United States; to promote and maintain high professional and moral standards; to assist in the maintenance of high standards for the certified public accountant certificate in the several states; to safeguard the interests of public accountants; to advance the science of accountancy; to develop and improve accountancy education; to provide for the examination of candidates for membership; and to encourage cordial intercourse among accountants practising in the United States of America.

ARTICLE II

MEMBERSHIP

SECTION 1. The Institute shall consist of members and associates.

SEC. 2. Members shall be:

(a) Fellows of the American Association of Public Accountants at September 19, 1916, admitted to membership prior to November 1, 1916.

(b) Persons who shall qualify for examination and election as provided in section 4 of this article and shall be recommended by the board of examiners after examination and shall be elected by the council.

(c) Members of the American Society of Certified Public Accountants in good standing as of August 31, 1936, who shall elect to become members.

(d) Associates of the Institute in good standing as of August 31, 1936, who elect to become members.

SEC. 3. Associates shall be:

(a) Associate members of the American Association of Public Accountants at September 19, 1916, admitted as associates prior to November 1, 1916.

(b) Persons who shall qualify for examination and election as provided in section 5 of this article and shall be recommended by the board of examiners after examination and shall be elected by the council.

(c) Members of the American Society of Certified Public Accountants in good standing as of August 31, 1936, who shall elect to become associates.

SEC. 4. The following persons may qualify for examination and election as members of the Institute provided that they be not less than twenty-one years of age and shall present evidence of preliminary education satisfactory to the board of examiners:

(a) Associates who shall meet the requirements stated in the following paragraphs of this section.

(b) Accountants engaged in public practice, or accountancy instruction in schools recognized by the board of examiners, who shall have been in practice or in accountancy instruction for a period of not less than five years. The board shall satisfy itself in each case that the applicant's experience has been sufficiently continuous and of such a character as to warrant his admission to membership. The board may give credit in its discretion for accountancy work of an outstanding character which in its opinion is clearly equivalent to public practice.

(c) After January 1, 1936, no applicant shall be admitted as a member unless he holds a valid and unrevoked certified public accountant certificate issued by the legally constituted authorities of a state or territory of the United States of America or of the District of Columbia.

(d) Any associate engaged in public practice who shall have been in possession of a certified public accountant certificate for more than ten years and shall be eligible for advancement to membership shall automatically be advanced to membership.

SEC. 5. The following persons may qualify for examination and election as associates of the Institute, provided, that they shall be not less than twenty-one years of age and shall present evidence of preliminary education satisfactory to the board of examiners:

(a) Accountants who shall have been in practice on their own account or in the employ of a practising public accountant for not less than two years, or shall have had experience which in the opinion of the board of examiners is equivalent to two years' public accounting practice, and at the date of application shall be engaged in work related to accounting.

(b) Accountants who shall have been engaged in accountancy instruction in schools recognized by the board of examiners for a period of not less than three years next preceding the date of application, provided

(c) After January 1, 1936, no applicant shall be admitted as an associate unless he holds a valid and unrevoked certified public accountant certificate issued by the legally constituted authorities of a state or territory of the United States of America or of the District of Columbia.

SEC. 6. All credits for education and experience shall be allotted by the board of examiners, and the board shall have discretion to determine whether or not any applicant's experience is of a nature satisfactory for purposes of these by-laws.

SEC. 7. Upon election each member or associate shall be entitled to a certificate setting forth that he is a member or an associate of the Institute, but no certificate shall be issued until receipt of initiation fee and dues for the current year. Certificates of membership shall be returned to the council upon suspension or termination of membership for any cause except death.

SEC. 8. Members of the Institute shall be entitled to describe themselves as Members of the American Institute of Accountants and associates as Associates of the American Institute of Accountants.

ARTICLE III

SECTION 1. The dues for each fiscal year shall include the cost of subscription to *The Journal of Accountancy* and the *Yearbook* of the Institute and shall be as follows:

By each member.................................... $25
By each associate who shall have been in possession of a certified public accountant certificate for less than five years.. 10
By each associate who shall have been in possession of a certified public accountant certificate for more than five years.. 15

SEC. 2. All dues shall be paid in advance and shall be apportioned in the first instance to the end of the fiscal year. No dues shall be paid by members and associates of the Institute while they are engaged in military or naval service of the United States or its allies during war. Members of the Institute who have reached advanced years may be excused from the payment of dues on the recommendation of the executive committee.

ARTICLE IV

VOTING

SECTION 1. Every member of the Institute shall be entitled to attend all meetings of the Institute and to cast a vote upon all questions brought before such meetings.

SEC. 2. Associates of the Institute shall not be entitled to vote, but may attend all meetings of the Institute and have the privilege of the floor in the discretion of the chair or of the meeting in session.

SEC. 3. Any member of the Institute may be represented at regular and special meetings of the Institute by another member acting as his proxy, provided, however:

(a) That no person shall act as a proxy for more than five members.

(b) That no proxy given shall confer power of substitution and that all proxies shall be valid only for the meeting for which specifically given.

ARTICLE V

TERMINATION OF MEMBERSHIP

SECTION 1. Resignations of members and associates may be offered in writing at any time and shall be effective on the date of acceptance. Action upon the resignation of a member or an associate in good standing shall be taken by the executive committee and, in the case of a member or an associate under charges, by the council.

SEC. 2. A member or an associate who fails to pay his annual dues or any subscription, assessment or other obligation to the Institute within five months after such debt has become due shall automatically cease to be a member or an associate of the Institute, unless in the opinion of the executive committee it is not in the best interests of the profession that his membership be terminated in this way.

SEC. 3. (a) A member or an associate who shall resign while in good standing may be reinstated by a three-fourths vote of the members of council present and voting at any regular or special meeting of council, provided the person applying shall submit with his application for reinstatement the amount of dues and assessments, subscriptions, etc., not in any case to exceed $25, which would have been payable by him if he had continued in membership from the time of resignation to the date of application for reinstatement.

(b) The executive committee, in its discretion, may reinstate a member or an associate whose membership shall have been forfeited for nonpayment of dues or other sums due by him to the Institute, provided that the person applying shall submit with his application for reinstatement the amount of dues and assessments, subscriptions, etc., which would have been payable by him if he had not forfeited his membership, plus a fine of $10.

(c) No person shall be considered to have resigned while in good standing if at the time of his resignation he was in debt to the Institute for dues or other obligations. A member submitting his resignation after the beginning of the fiscal year, but before expiration of the time limit for payment of dues or other obligation, may attain good standing by paying dues prorated according to the portion of the fiscal year which has elapsed, provided obligations other than dues shall have been paid in full.

SEC. 4. A member or an associate renders himself liable to expulsion or suspension by the council sitting as a trial board if

(a) he refuses or neglects to give effect to any decision of the Institute or of the council, or

(b) he infringes any of these by-laws or any of the rules of professional conduct as approved by the council of the Institute, or

(c) he is declared by a court of competent jurisdiction to have committed any fraud, or

(d) he is held by the council to have been guilty of an act discreditable to the profession, or

(e) he is declared by any competent court to be insane or otherwise incompetent, or

(f) his certificate as a certified public accountant is revoked or withdrawn by the authority of any state or territory of the United States or of the District of Columbia, or

(g) his certificate as a certified public accountant shall have been revoked or withdrawn by the authority of any state or territory of the United States or of the District of Columbia and such revocation or withdrawal remains in effect.

SEC. 5. A member or an associate shall be expelled if the council sitting as a trial board finds by a majority vote of the members present and entitled to vote that he has been convicted of a felony or other crime or misdemeanor involving moral turpitude. If in such a case the conviction shall be reversed by a higher court, such member or associate may request reinstatement and such request shall be referred to the committee on professional ethics which, after investigating all related circumstances, shall report the matter to the council with the committee's recommendation, whereupon the council sitting as a trial board may by a majority vote of the members present and entitled to vote reinstate said member or associate.

ARTICLE VI

TRIALS AND PENALTIES

SECTION 1. Any complaint preferred against a member or an associate under section 4 of article V shall be submitted to the committee on professional ethics. If, upon consideration of a complaint, it appears to the committee that a prima-facie case is established showing a violation of any by-law or rule of conduct of the Institute or conduct discreditable to a public accountant, the committee on professional ethics shall report the matter to the executive committee, which shall summon the member or associate involved thereby to appear in answer at the next regular or special meeting of the council.

SEC. 2. If the committee on professional ethics shall dismiss any complaint preferred against a member or an associate, or shall fail to act thereon within ninety days after such complaint is presented to it in writing, the member or associate preferring the complaint may present the complaint in writing to the council. The council shall make such investigation of the matter as it may deem necessary and shall either dismiss the complaint or refer it to the executive committee, which shall summon the member or associate involved thereby to appear in answer at the next regular or special meeting of the council.

SEC. 3. For the purpose of adjudicating charges against members or associates of the Institute as provided in the foregoing sections, the council shall convene as a trial board. Members of the committee on professional ethics shall not be entitled to vote as members of the trial board. The executive committee shall instruct the secretary to send due notice to the parties concerned at least thirty days prior to the proposed session. After hearing the evidence presented by the committee on professional ethics or other complainant and by the defense, the trial board by a two-thirds vote of the members present and entitled to vote may admonish or suspend for a period of not more than two years the member or associate against whom complaint is made or by a three-fourths vote of the members present and entitled to vote may expel the member or associate against whom complaint is made. A statement of the case and the decision of the trial board thereon, either with or without the name of the person involved, shall be prepared by the executive committee and published in *The Journal of Accountancy*.

SEC. 4. At any time after the publication in *The Journal of Accountancy* of a statement of the case and decision of the trial board thereon the council, sitting as a trial board, members of the committee on professional ethics not being entitled to vote, by a three-fourths vote of the members present and entitled to vote may recall, rescind or modify such expulsion or suspension.

ARTICLE VII

COUNCIL AND OFFICERS

SECTION 1. The governing body of the Institute shall be a council consisting of:

(a) Thirty-five members in practice, to be increased by the following method to forty-eight members in practice, not more than six of whom shall be residents of the same state: At each of the annual meetings in 1940 and 1941, nine members in practice shall be elected for a term of three years or until their successors shall have been elected; thereafter, sixteen members in practice shall be elected at each annual meeting for a term of three years or until their successors shall have been elected; and

(b) The following officers of the Institute: a president, two vice presidents (both vice presidents shall not be residents of one state), and a treasurer, all of whom shall be members in practice and shall be elected at the annual meeting for a term of one year or until their successors shall have been elected, and

(c) All past presidents who are members of the Institute.

SEC. 2. The same person shall not hold the office of president for more than two successive years.

SEC. 3. The council shall elect a secretary of the Institute who shall act as an executive officer under the direction of the council. The secretary may be chosen from without the membership of the Institute, but he shall have the privilege of the floor at meetings of the Institute, the council and the executive committee.

SEC. 4. The Institute at each annual meeting shall elect two auditors, who shall audit the accounts for the current fiscal year and report at the next annual meeting. The books and accounts shall be submitted by the treasurer for audit at least one week preceding the date of the annual meeting.

SEC. 5. In the event of a vacancy or vacancies occurring between meetings of the Institute in the membership of the council or in any of the executive offices of the Institute, the council shall be empowered to elect a member or members to fill such vacancy or vacancies until the next annual meeting or until a successor or successors shall have been elected. Such election shall be by majority vote of the council and may take place at any regular or special meeting of the council or, in lieu of a meeting, nominations may be called for by the president and the names of the nominees submitted to the members of council for election by mail ballot. Vacancies in the membership of the council shall be filled at the next annual meeting by election by the Institute for the unexpired terms.

SEC. 6. Except in the case of past presidents the office of a member of council shall be rendered vacant by his absence from four consecutive meetings of the council.

ARTICLE VIII

DUTIES OF COUNCIL AND OFFICERS

SECTION 1. It shall be the duty of the president or, in his absence, of one of the vice presidents or other members of the council designated by the council to preside at all meetings of the Institute and of the council. The president shall call special meetings of the Institute or of the council when he deems it necessary, or when requested to do so by the executive committee, or upon the written request of at least one hundred members of the Institute for a meeting of the Institute, or of at least five members of the council for a meeting of the council. Special meetings of the Institute or of the council shall be held at places designated by the executive committee.

The duties of the vice presidents and the treasurer shall be those usually appertaining to their respective offices.

The secretary, in addition to performing the usual duties of his office, shall discharge such other duties as may be assigned to him by the council or by the executive committee. The secretary of the Institute shall be the secretary of all committees.

SEC. 2. It shall be the duty of the council to take control and management of all the property of the Institute, to elect or appoint such agents or employees as may be necessary for the proper conduct of the affairs of the Institute, to keep a record of its proceedings and to report to the Institute at each annual meeting. The council shall exercise all powers requisite for the purposes of the Institute.

SEC. 3. The council shall adopt an annual budget showing the money appropriated for the purposes of the Institute and estimating the revenue for the ensuing year. No debts shall be contracted nor money expended otherwise than as provided in the budget without the approval of a majority of the council.

SEC. 4. The council may, in its discretion, delegate to the executive committee all functions of the council except the election of officers and members, the right to review the rules and regulations of the board of examiners, discipline of members, filling a vacancy in the executive committee and the adoption or alteration of a budget.

ARTICLE IX

COMMITTEES

SECTION 1. There shall be fifteen regular standing committees, namely:

EXECUTIVE
PROFESSIONAL ETHICS
ACCOUNTING PROCEDURE
AUDITING PROCEDURE
ARBITRATION
BUDGET AND FINANCE
BY-LAWS
CREDENTIALS
EDUCATION
FEDERAL TAXATION
MEETINGS
NOMINATIONS
PUBLICATION
STATE LEGISLATION
TERMINOLOGY

SEC. 2 (a) The executive committee shall consist of the president, two vice presidents and the treasurer of the Institute and seven other members of the council elected by the council. Four members of the committee shall constitute a quorum of the executive committee.

(b) The committee on professional ethics shall be elected by the council and shall consist of five members of the council not members of the executive committee.

(c) The committee on nominations shall consist of seven members. Two members of the committee shall be elected by the council from its membership at the meeting of the council held on the Monday preceding the annual meeting of the Institute or at any adjournment thereof. Officers and other members of the council whose terms expire within one year shall not be elected to the committee on nominations. The five remaining members of the committee shall be elected by the Institute at the annual meeting and shall be members in practice who are not officers or members of the council. The member of the nominating committee first named by the council shall serve as temporary chairman of the committee until the committee itself, by mail vote or at a duly called meeting, shall elect a permanent chairman.

(d) The committee on education shall consist of five members appointed by the president for a term of three years, except that, of the members first appointed, one shall serve for a term of one year, two for a term of two years, and two for a term of three years. Appointments to fill vacancies occurring before the end of a term shall be for the unexpired term only.

(e) All other standing committees shall be appointed by the president. The president shall also have power in his discretion to constitute and appoint special committees as occasion may arise.

(f) Except as provided above, all committees shall consist of a chairman and not less than two other members of the Institute and shall serve until the annual meeting of the Institute next following their election or appointment.

SEC. 3. The president of the Institute shall be ex officio a member of all committees.

SEC. 4. Except in the case of the executive committee a majority of each committee shall constitute a quorum for the transaction of business. All committees shall be subject to the call of their respective chairmen, but, in lieu of a meeting of a committee, the chairman may submit any question to the members of the committee for vote by mail, and any action approved in writing by not less than two-thirds of the whole committee shall be declared an act of the committee.

ARTICLE X

DUTIES OF COMMITTEES

SECTION 1. The duties of the various committees shall be as described in this article and, in addition, such other duties as are indicated by their respective titles.

SEC. 2. The executive committee shall administer the affairs of the Institute, supervise the finances and exercise such other powers as may be designated by the council. It shall keep minutes of its proceedings and shall report fully to the council at each meeting thereof.

No payments except for duly authorized salaries shall be made by the treasurer without the approval of the executive committee.

SEC. 3. The committee on professional ethics shall perform the duties set forth in section 1 of article VI and may advise anyone applying to it as to whether or not a submitted action or state of facts warrants a complaint against a member or an associate of the Institute, provided, however, that if the committee finds itself unable to express an opinion, such inability shall not be construed as an endorsement of the action or state of facts.

SEC. 4. The committee on arbitration shall sit as a committee in equity to investigate and decide disputes between members or associates of the Institute or others which shall, by agreement of the parties, be submitted to the committee in due form. If the decision of the committee on arbitration in any dispute be rejected by any member or associate of the Institute, the matter shall be reported to the council, which may instruct the executive committee to prefer charges against the offending member or associate if it shall decide, by a two-thirds vote of members present, that the recommendation of the committee on arbitration should have been accepted.

SEC. 5. The committee on credentials shall convene immediately after the annual meeting of the Institute shall have been called to order and at any time during the meeting may register proxies submitted to it. Only proxies validated by this committee shall be entitled to vote.

SEC. 6. The committee on publication shall supervise *The Journal of Accountancy.*

ARTICLE XI

NOMINATION AND ELECTION OF OFFICERS AND MEMBERS OF COUNCIL

SECTION 1. (a) Nominations for officers and members of the council shall be made by the committee on nominations at least sixty days prior to the date of the annual meeting at which the elections are to take place. Notice of such nominations shall be mailed by the secretary to all members at least thirty days prior to the annual meeting.

Before making its nominations the committee on nominations shall send, at least four months prior to the date of the annual meeting, to all the members of the Institute in those states from which, in the opinion of the committee, members should be elected to the council in that year, a questionnaire requesting the submission within thirty days of names of members resident in the state concerned for election to the council. Nominees for the council shall be selected by the committee on nominations from among the names submitted in response to this request by members of the Institute in the states entitled to representation.

(b) Any ten members of the Institute may submit independent nominations, provided that such nominations be filed with the secretary at least twenty days prior to the date of the annual meeting. Notice of such independent nominations shall be mailed by the secretary to all members at least ten days prior to the annual meeting.

(c) Nominations for officers and members of council may be made from the floor at the time of the annual meeting only by the consent of the majority of the members present in person.

SEC. 2. Election of officers, members of council and auditors shall be by ballot. The president shall appoint a chairman and two tellers, who shall receive and count the ballots cast for each officer, member of council and auditor and shall announce the result to the presiding officer. A majority of votes shall elect.

If there be no majority on the first ballot for any one or more officers or members of council or auditors, additional ballots shall be taken at once for the particular office or offices to which there shall have been no election until an election be effected.

SEC. 3. The members present at any election of officers, members of council and auditors, and eligible to vote in such election, may direct the secretary to cast a ballot for any nominee or nominees for such office or offices, and election by such ballot shall be valid and effective.

ARTICLE XII

EXAMINATIONS

SECTION 1. The examination of candidates for admission to the Institute shall be under the supervision of a board of examiners, which shall consist of nine members in practice, three of whom shall be elected each year by the council, at its first meeting after the annual meeting of the Institute, to serve for a term of three years.

SEC. 2. The board of examiners shall hold simultaneous examinations for candidates either annually or semiannually, as it may deem expedient at such places in different parts of the country as it may select, where candidates for admission may conveniently attend. Such examinations shall be oral or written or partly oral and partly written, and by this method or such other methods as may be adopted, the board of examiners shall determine the preliminary education and training and the technical qualifications of all candidates for admission before the applications shall be submitted to the council.

SEC. 3. The board of examiners shall organize by the election of a chairman and shall formulate the necessary rules and regulations for the conduct of its work, but all such rules and regulations may be amended, suspended or revoked by the council. The board may appoint duly qualified examiners to prepare examination questions and to grade the papers of applicants. Each applicant shall pay an examination fee, which shall be applied to the payment of expenses incident to examinations.

ARTICLE XIII

MEETINGS

SECTION 1. There shall be a regular meeting of the Institute on the third Tuesday of September or the third Tuesday of October of each year as the executive committee shall decide. The fiscal year of the Institute shall end with the 31st day of August of each year.

SEC. 2. Special meetings of the Institute may be convened as provided in article VIII, section 1, at such places as the executive committee shall designate. No business shall be transacted at such meetings other than that for which the meetings shall have been convened.

SEC. 3. Notice of each meeting of the Institute, whether regular or special, shall be mailed to each member and associate of the Institute, at his last-known address, at least thirty days prior to the date of such meeting.

SEC. 4. In lieu of a special meeting, the Institute in meeting assembled may direct, or the council by a majority vote may direct, that the president submit any question to the entire membership for a vote by mail, and any action approved in writing by not less than a majority of the members of the Institute shall be declared by the president an act of the Institute and shall be so recorded in its minutes. Mail ballots shall be valid and counted only if received within sixty days after date of mailing ballot forms from the office of the Institute.

SEC. 5. Regular meetings of the council shall be held on the Thursday next after the date of the annual meeting of the Institute, the second Monday in April and the Monday next preceding the date of the annual meeting of the Institute.

SEC. 6. Special meetings of the council may be called as provided in article VIII, section 1, of these by-laws.

SEC. 7. Notice of each meeting of the council except the meeting on the Thursday after the date of the annual meeting of the Institute, shall be sent to each member of the council at his last-known address twenty-one days before such meeting. Such notice as far as practicable shall contain a statement of the business to be transacted.

SEC. 8. A transcript of the minutes of each meeting shall be forwarded to each member of the council within thirty days after such meeting.

SEC. 9. In lieu of a special meeting of the council the president may submit any question to the council for vote by mail and any action approved in writing by not less than two-thirds of the whole membership of the council shall be declared by the president an act of the council and shall be recorded in the minutes of the council.

SEC. 10. Fifty members of the Institute shall constitute a quorum for the transaction of any business duly presented at any meeting of the Institute. Twenty members of the council shall constitute a quorum of the council.

SEC. 11. The rules of parliamentary procedure contained in Robert's *Rules of Order* shall govern all meetings of the Institute and of the council.

ARTICLE XIV

ADVISORY COUNCIL

The Institute shall invite presidents of the recognized societies of certified public accountants in the several states and territories of the United States of America and the District of Columbia to form an advisory council of state society presidents.

The advisory council shall at all times consist of the state society presidents then holding office in their respective societies, but if a member of the advisory council is unable to attend a meeting of the advisory council a member of his society may be designated by the society to represent him at the meeting.

At least once in each year the Institute shall convene the advisory council which shall choose its own chairman and secretary. A majority of the members of the advisory council shall constitute a quorum.

The advisory council shall consider matters submitted to it from time to time by the council of the Institute and in its discretion shall make recommendations to the council of the Institute. A full report of the transactions of the advisory council shall be submitted to the membership of the Institute at the same time as committee reports.

ARTICLE XV

AMENDMENTS

The secretary shall embody in the call for the annual meeting all proposals to amend the by-laws prepared by the committee on by-laws for submission to such meeting, and any other proposals to amend the by-laws of which he shall have had notice in writing signed by thirty or more members in good standing at least sixty days prior to the date of such meeting. All such proposals to amend the by-laws shall be presented for vote of the members at the annual meeting, and by consent of the majority of the members present in person other proposals to amend the by-laws which are made by members present in person at the meeting may be presented for vote of the members at any annual meeting. Any proposal to amend the by-laws, if approved by a two-thirds' vote of the members present at such meeting in person or by proxy, shall be submitted to all of the members of the Institute for a vote by mail, and if approved in writing by a majority of the members of the Institute shall become effective as an amendment to the by-laws. Mail ballots shall be valid and counted only if received within sixty days after date of mailing ballot forms from the office of the Institute.

RULES OF PROFESSIONAL CONDUCT

As revised and adopted Jan. 6, 1941

(These rules of conduct supplement the disciplinary clauses of the by-laws.)

(1) A firm or partnership, all the individual members of which are members of the Institute (or in part members and in part associates, provided all the members of the firm are either members or associates), may describe itself as "Members of the American Institute of Accountants," but a firm or partnership, not all the individual members of which are members of the Institute (or in part members and in part associates), or an individual practising under a style denoting a partnership when in fact there be no partner or partners, or a corporation, or an individual or individuals practising under a style denoting a corporate organization shall not use the designation "Members (or Associates) of the American Institute of Accountants."

(2) A member or an associate shall not allow any person to practise in his name who is not in partnership with him or in his employ.

(3) Commissions, brokerage or other participation in the fees or profits of professional work shall not be allowed directly or indirectly to the laity by a member or an associate.

Commissions, brokerage or other participation in the fees, charges or profits of work recommended or turned over to the laity as incident to services for clients shall not be accepted directly or indirectly by a member or an associate.

(4) A member or an associate shall not engage in any business or occupation conjointly with that of a public accountant, which is incompatible or inconsistent therewith.

(5) In expressing an opinion on representations in financial statements which he has examined, a member or an associate shall be held guilty of an act discreditable to the profession if:

(a) He fails to disclose a material fact known to him which is not disclosed in the financial statements but disclosure of which is necessary to make the financial statements not misleading; or

(b) He fails to report any material misstatement known to him to appear in the financial statements; or

(c) He is grossly negligent in the conduct of his examination or in making his report thereon; or

(d) He fails to acquire sufficient information to warrant expression of an opinion, or his exceptions are sufficiently material to negative the expression of an opinion; or

(e) He fails to direct attention to any material departure from generally accepted accounting principles or to disclose any material omission of generally accepted auditing procedure applicable in the circumstances.

(6) A member or an associate shall not sign a report purporting to express his opinion as the result of examination of financial statements unless they have been examined by him, a member or an employee of his firm, a member or an associate of the Institute, a member of a similar association in a foreign country, or a certified public accountant of a state or territory of the United States or the District of Columbia.

(7) A member or an associate shall not directly or indirectly solicit the clients or encroach upon the practice of another public accountant, but it is the right of any member or associate to give proper service and advice to those asking such service or advice.

(8) Direct or indirect offer of employment shall not be made by a member or an associate to an employee of another public accountant without first informing such accountant.

(9) Professional service shall not be rendered or offered for a fee which shall be contingent upon the findings or results of such service. This rule does not apply to cases such as those involving federal, state or other taxes, or other matters in which the findings are those of the tax or other similar authorities and not those of the accountant.

(10) Members or associates shall not advertise their professional attainments or services, but the publication of what is technically known as a card is not prohibited by this rule. A card is defined as an advertisement of the name, title (member of American Institute of Accountants, C.P.A., or other professional affiliation or designation), class of service, and address of the advertiser, or announcement of change of address or personnel of firm, not exceeding two columns in width and three inches in depth if appearing in a newspaper, or not exceeding one-quarter of a page if appearing in a magazine, directory, or similar publication.

(11) A member or an associate shall not be an officer, director, stockholder, representative or agent of any corporation engaged in the practice of public accounting in any state or territory of the United States or the District of Columbia.

(12) A member or an associate shall not permit his name to be used in conjunction with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that the member or associate vouches for the accuracy of the forecast.

(13) A member or an associate shall not express his opinion on financial statements of any enterprise financed in whole or in part by public distribution of securities, if he is himself the actual or beneficial owner of a substantial financial interest in the enterprise or if he is committed to acquire such an interest; nor shall a member or an associate express his opinion on financial statements which are used as a basis of credit, if he is himself the actual or beneficial owner of a substantial financial interest in the enterprise or if he is committed to acquire such interest, unless he discloses his financial interest in his report.

(14) A member or an associate shall not make a competitive bid for professional engagements in any state, territory or the District of Columbia, if such a bid would constitute a violation of any rule of the recognized society of certified public accountants or the official board of accountancy in that state, territory, or district.

(15) A member or an associate of the American Institute of Accountants engaged simultaneously in the practice of public accounting and in another occupation must in both capacities observe the by-laws and rules of professional conduct of the Institute.